

EXHIBIT 35

DECENTRALIZATION, TAX EVASION, AND THE UNDERGROUND ECONOMY:

A MODEL WITH EVIDENCE FROM RUSSIA

Economic models of decentralization generally emphasize beneficial consequences—efficient provision of local public goods, hard budget constraints, and sorting of residents according to taste. This paper notes two less benign effects. First, political decentralization makes it easier for subnational governments to collude with enterprises at the center's expense, offering firms political protection against central tax collectors and bankruptcy agents ("regional fiscal protection"). Second, because multiregional enterprises have a larger set of potential regional protectors, political decentralization advantages them over smaller, single-region firms (the "multiregional advantage"). Fiscal decentralization alleviates some problems, but exacerbates others such as the shift of output underground. A simple model shows how these and other phenomena follow from the assumption of revenue-maximizing governments in a state with inter-level revenue-sharing and imperfect law enforcement. Various predictions of the model are compared to recent economic experience in Russia and are found to fit remarkably well. Many problems—including official stagnation, booming underground economy, growing interregional fiscal inequality, economic dominance of the "oligarchs", falling federal tax revenues, and frequent economic conflict between central and regional governments—that are often explained by ad hoc and personal factors (Yeltsin's health, high-level corruption, misguided economic reform strategies) can all be traced at least in part to the logic of competition in a decentralizing, revenue-sharing state.

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First version: August 1999; revised January 2000

Comments welcome. I am grateful to Ani Sarkissian for research assistance, to Gérard Roland, Jean-Laurent Rosenthal, Hongbin Cai and other participants in the UCLA Economic History seminar, Andrew Barnes, Leonid Polishchuk and participants in the December 1999 RECEP conference on Institutions and Growth for comments, and to the Smith Richardson Foundation and UCLA Academic Senate for support.

I. INTRODUCTION

Since Tiebout (1956), numerous models have explored potential benefits derived from political and fiscal decentralization. In decentralized systems, subnational governments will compete to attract mobile residents and investors, and this competition should induce them to provide public goods efficiently. Such interregional competition for capital may increase the cost to regional governments of subsidizing unprofitable enterprises, hardening budget constraints (Qian and Roland 1998). At the same time, decentralized provision of public goods may make possible a more efficient match with citizens tastes (Oates 1972).

While broadly accepting these arguments, some subsequent authors have suggested modifications to their more optimistic implications (e.g., Oates 1981). Even if all subnational governments are motivated to satisfy the demands of local residents efficiently, this may not lead to socially optimal outcomes because of externalities and spillovers between regions (Pauly 1970; Gordon 1983). Bewley showed that even in theory, a rigorous and somewhat unlikely set of assumptions must be met for the Tiebout result to hold (Bewley 1981). The usual implication drawn from such findings has been that some interventions by the central government in a federal system may be justified to correct failures of the Tieboutian market (e.g., Wildasin 1989, Gordon 1983).

More recently, a more radical critique of the arguments for decentralization has begun to emerge. In part, this has been prompted by the growing uneasiness of some empirical scholars, who observe numerous apparent inefficiencies in existing federal states, especially in the developing world. Prud'homme (1995) and Tanzi (1995) suggest that corruption may be more widespread in more decentralized political systems, and Treisman (1997, 1999a) finds robust evidence that federations are

perceived to be more corrupt than unitary states. Decentralized political institutions in Brazil, Argentina, Russia, China, and the former Yugoslavia have been blamed for macroeconomic imbalances and fiscal pathologies. Dillinger and Webb (1998) recount how political pressures from subnational governments led to federal bailouts of overextended provincial banks in Argentina and Brazil. Saiegh and Tommasi (1999) describe incentive problems in the Argentine system of federal finance. Freinkman and Haney (1997) find that federal transfers to Russian regional governments, rather than correcting interregional externalities, have led to increased subsidization of inefficient enterprises. Shleifer and Treisman (1999) argue that the particular division of tax and regulatory rights between federal and regional governments in Russia in the 1990s helps to explain the country's stagnant official economic growth, booming underground economy, and falling federal tax revenues.

This article extends this critique in two ways. The first is to note the phenomenon of "regional fiscal protection". In a politically decentralized state, the efficient provision of public goods is not the only way in which subnational governments can attract business to the region. They can also compete to offer "protection" to enterprises against the central government's tax collectors, regulators, or bankruptcy agency. The risk to enterprises of refusing to pay central taxes and running up arrears is reduced by the active support of a regional government, which can lobby on the enterprise's behalf in central state bodies and can threaten to mobilize demonstrations of angry voters if its protégé enterprise is harmed. In a "second best" world, such protection may not be all bad. It may actually have welfare-enhancing effects if providing protection wastes fewer resources than concealing output (and enterprises substitute "regionally protected" for underground production), or if central taxes are set at a suboptimally high rate.¹ But the regional governments' aid to tax delinquents may drive federal tax receipts below the level necessary to

¹ Aggregate tax rates in a federal state are likely to be suboptimally high if both federal and regional governments can co-occupy the same tax base (Berkowitz and Li 1997). This distortion may be reduced by the traditional kind of Tiebout horizontal competition (Brennan and Buchanan 1980), but it will not be eliminated unless mobility is completely costless and regional extraction is driven to zero. For an excellent analysis of this issue, see Keen and Kotsogiannis (1996).

fund the optimal supply of public goods. And the visible results of such collusion will be disconcerting: high federal tax arrears and incessant political conflict between central and regional governments.

The second addition to the literature on the economics of decentralization concerns a distortion found in politically decentralized states which I label the “multiregional advantage”. The enhanced opportunities for collusion between business and regional governments produced by political decentralization will in practice favor large, multiregional enterprises over small firms for reasons that have nothing to do with productive efficiency or innovation. The multiregional enterprise will have a larger set of potential protectors. For any given regional governor colluding to help a given firm, shielding the first thousand dollars from central tax-collectors will be easier than shielding the next thousand. Thus, a firm whose activities are spread out over a number of regions will be able to mobilize greater protection at lower cost. There will be economies of geographical scale in cheating the central government. When, in addition, an enterprise can shift its tax base around between regions at the stroke of a pen through transfer pricing, it can also demand a larger share of the rents from such collusion. As a result, large, multiregional firms will buy more regional protection, run up proportionally larger tax arrears, and retain larger net returns than single-region enterprises. Furthermore, increased political or fiscal decentralization will usually enhance the multiregional advantage. If, as is often argued, it is small firms rather than multi-divisional conglomerates that are the leading engine of innovation and growth, this distortion will reduce growth in such economies.

In section II, I develop a model that incorporates both regional fiscal protection and the multiregional advantage. It implies three sets of predictions, about: (1) the consequences of increasing political decentralization (in the sense of any change that reduces the cost to regional governments of defying the central government), (2) the effects of increasing fiscal decentralization (in the sense of increasing the subnational share in shared taxes), and (3) the different outcomes for multiregional and

EXHIBIT 36

Financial Crisis: Taxation System Reform Requirements

V. S. Panfilov

Abstract—A brief analysis is made of the negative aftereffects of the economic reform strategy of 1992–1998, which led to a virtual breakdown of Russia's financial system in August 1998. A set of measures, both tactical and strategic in nature, in the field of fiscal and monetary policies aimed at curbing the spread of the crisis and coming to the economic growth path, is proposed.

Characteristics of Russia's monetary and financial situation. The main characteristic of today's monetary and financial situation, as we see it, is that *the default on internal government obligations, the slump of the ruble's exchange rate, and the breakdown of the payments and banking system are natural consequences of the socioeconomic system that has developed in the Russian Federation during the 1990s.* This situation is rooted in the widespread unreliability in discharging one's obligations. Nonpayments between economic entities, the virtual impossibility to get a debt repaid by legitimate means, alongside the government's failure to pay its bills (salary and pension delays, nonpayment for government orders) have gradually led to a typological change in the economic entities' behavior. Their behavior today, unlike an economically helpful one which seeks to cut production costs, save on expenditures, and raise the efficiency of investments, is characterized by the failure to pay the supplier for goods, wages to their employees, taxes to the government, or to repay their debts using every pretext. People pay when they cannot avoid it for procedural reasons (required prepayment) or for fear of cruel reprisals from the creditor. It is only natural that where this kind of economic behavior prevails for an extended period of time it is bound to lead to an actual bankruptcy of the economic system, including the state itself.

The most painful effect of the state's bankruptcy is the inevitable fall of living standards, at least in the short run, by at least 30%. With the collapse of the ruble the population has come face to face with the existing economic reality. Now is the time to pay for the failures of the previous economic and financial policy and for an inefficient economy.

In analyzing the fiscal and financial policy of recent years one is led to conclude that it had no strategic goals. Measures to achieve stated goals, i.e., suppression of inflation and contraction of the budget gap, were taken without regard for, and often to the detriment of,

the stability of the monetary and financial systems. As a result, these systems face major financial shocks annually: a currency crisis in October 1994, a banking crisis (an interbank market crisis) in August 1995, a national debt market crisis in 1996, an extreme aggravation of the fiscal crisis in 1997. These shocks occur against the backdrop of a lasting payments crisis and a growing "barterization" of the economy.

The most significant result of the monetary system reform has been a virtually complete separation between currency issue and the economy's payment and settlement needs. The abolition of a reports of payments calendar and payment requests in 1992, the discontinuance of centralized credits and a statutory ban on direct Central Bank credits to the national budget were major steps which had the effect of eliminating the link, largely inflationary but unquestionable, which existed between economic and money turnover.

As a consequence, before the declaration of default currency, money issues (if we disregard Central Bank purchases of precious metals from domestic producers) were connected with financial market operations: the purchases by the Central Bank of hard currency, GKO's (Government Short-Term Bonds) and OFZs (Federal Loan Bonds), and its crediting of commercial banks against government securities. Given all that, the inflow of extra money into the economy did not improve the situation of real sector enterprises but became a resource for speculative assets in the financial sector.

The absence of "long money," viz. long-term real sector crediting and long-term liabilities for banks and financial intermediaries, is another consequence of the reform. Even in the best of times the most trustworthy borrower, the state, could not hope to borrow money in the domestic market at a reasonable interest for longer than 1.5 years.

One important characteristic of the finance and credit system is the retention of the Central Bank's excessive share in the banking system's aggregate balance. The development of an effective banking system

the GDP. Naturally, sustaining this load is beyond the strength of Russia's production sector.

At present, practically every branch of the manufacturing industry, coal industry, and agriculture has proven to be unprofitable. On the whole, the proportion of loss-making enterprises reached 49% (in the first six months of 1998) and the balanced financial performance of the enterprises and organizations in industry, construction, and transportation was down nearly 30% from the first half-year of 1997. If we recalculate the profitability index using profit after tax we find that, until recently, the sphere of circulation alone was profitable. Even the sectors that are natural monopolists faced difficulties in financing simple reproduction.

Arguably, every economic entity, with a few exceptions, is in effect insolvent. Furthermore, a sizable part of the enterprises cannot pay its workers their minimum living wage. Correspondingly, measures to lessen the real sector's tax burden have turned from economically expedient into imperative to the survival of the socio-economic system of the Russian Federation.

The demand balances of enterprises' and organizations' bank accounts have been shrinking for a long time. In other words, the financial situation of the principal payer was such as to preclude the full and timely payment of required taxes. The August 1998 collapse of the banking system simply paralyzed money and tax payments in Russia.

At the same time, there seems to be no alternative to measures tightening the payment discipline, above all in regard to taxes and other compulsory payments. Repressive measures (strictly within the law) should figure prominently among them, such as recovery against the debtor's property, including the personal property of factory managers and their family members. The settlement of tax payments is a separate problem which arose on account of commercial banks' insolvency. In the case of larger enterprises our attitude to property of a production nature should be very circumspect, and sanctions should be imposed by individual schemes within a public and legally approved framework.

Analyses show that nonmonetary forms of payment, despite all bans, have further developed and proliferated. It has become clear that the practices of clearance, barter transactions, and settlement by bills are not only due to a limited money supply but also a method of opposing the pressure of creditors, primarily taxation bodies. Nonmonetary settlements, which complicate the estimation of the actual cost of a debt, are a way of pursuing a policy of price differentiation which helps alleviate the shortage of effective demand, curb setbacks in production, and slash tax payments.

The problem of tax arrearages cannot be solved unless we address the general problem of nonpayment and, above all else, the binding force of the contracts that economic entities enter into. The fulfillment of its obligations by the state has a special psychological sig-

nificance. In this connection it appears that what is urgently required is personal material responsibility of the administrations of private and other enterprises for nonfulfilment of economic agreements and of government officials for failure to fulfil agreements they have signed on behalf of the state.

The maintenance of loss-making workshops by profit-making enterprises has been another important element of industry's adaptive policy. This policy is in many ways the cheapest (both for industry and for local authorities) way of funding overemployment and excess capacities, which is only possible up to a certain level of loss. This level has been surpassed, which was one of the reasons for the decrease in production in July 1998. On the other hand, a relatively low tax burden falls on the incomes of workers in the financial sphere owing to its broad opportunities for using hidden forms of remuneration of labor—loans, annuities, etc. A similar situation can be observed in the sphere of intermediate trade where broad access to cash creates opportunities for understating turnovers and, correspondingly, incomes and tax payments. This sufficiently explains the tight situation with tax revenues which developed before the banking system collapsed.

Developments in the banking sector and in financial markets have confirmed that, given the existing reproduction mechanism, it is not on the loan capital supply and demand that the cost of borrowing depends, but on the profitability pattern of financial instruments. The net result is that financial and trade intermediaries are still capable of receiving superprofits. The collapse of the banking system and the ruble merely modified the sources of these superprofits, while the task of their heavy taxation remains as pressing as before.

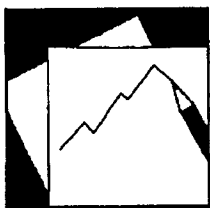
The current situation with tax receipts calls for drastic measures of regulatory and organizational nature with a view to drawing up a balanced draft budget for 1999, in terms of the possibility of its execution. These measures envision the lowering of the tax burden for producers (respectively, the onset of economic growth), the abolition of formal and informal privileges for the financial sector and the sphere of circulation, and resolute sanctions against gray turnover.

Steps to relieve the producer's tax burden and streamline the tax returns and expenditures of the state.

(1) To rapidly restructure the debt, receive as much ready money for the budget as possible, and above all to have all future payments to the budget made without any delay. In today's context, it is more important to ensure timely payments than to recover debts—and not just fines or penalties, but the sum of the debt itself.

(2) To immediately simplify the tax payment procedure for small and medium-sized enterprises, so as to have no more than two kinds of payments for the smaller enterprises, the social tax and the license (patent) fee, and three kinds of payments (the above plus VAT) for medium enterprises.

EXHIBIT 37



WP/00/155

IMF Working Paper

Determinants of Barter in Russia: An Empirical Analysis

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(Hypothesis 3) is an important determinant of non-monetary transactions between private enterprises. This can be concluded from the fact that overdue payables have a positive effect on non-monetary material purchases (offsets in particular), while illiquidity does not have a statistically significant effect. However, with respect to non-monetary payments to the public utilities and the budget, the illiquidity effect dominates, indicating that offsets with the public sector may be a way to alleviate liquidity pressures on illiquid firms. We scrutinize this issue further below.

Summing up, the empirical analysis lends some support to liquidity-based explanations for non-monetary transactions. In particular, we find that illiquidity, lack of access to bank credit, and high overdue payables are explanatory factors for non-monetary payments. The cross-sectional survey results presented here can thus help explain why NMTs have grown alongside arrears during the 1990s when demand was falling, bank credit to enterprises was scarce, and arrears were rising. However, the results also indicate a number of subtleties in the transmission mechanism from illiquidity to NMTs. Non-monetary transactions between firms are largely related to illiquid firms that are settling their arrears through offsets. By contrast, non-monetary transactions with the state and the public utilities seem to be directly motivated by enterprise liquidity problems, going beyond the arrears-offset mechanism. The special role of the state is the topic of the following section.

4.3 Role of the state and public utilities

In this section, we examine the hypothesis that the state has played a critical role in fostering non-monetary transactions by implicitly subsidizing companies through accepting goods in lieu of monetary tax and utility payments. As discussed in Section 3.2, the subsidy can consist both of an implicit interest-free credit (if the good is not immediately useful for the recipient) and an implicit price subsidy (if the good is overvalued).

We find some indirect evidence for the existence of implicit price subsidies in our survey: 40 percent of respondents reported offset prices in excess of cash prices for both revenues and costs. This pricing would be difficult to explain for pure barter where inflating prices in a bilateral exchange of goods may have no effect on the relative price of the two goods.²⁵ By contrast, inflating offset prices tends to skew the relative price in favor of the debtor. In particular, offsetting a given tax debt with an overvalued good will amount to an implicit price subsidy to the tax debtor. The root of the observed overpricing may thus be transactions with the state, with this feeding through into purely private deals. *Table 4.5* shows that higher offset prices tend to be associated with more extensive use of offsets, in particular for paying local government, indicating that inflated offset prices are seen as beneficial by debtors.

Under the implicit subsidy hypothesis, it is reasonable to assume that the state would focus its support on loss-makers rather than on profitable companies. We can thus test the theory by running regressions of non-monetary forms of payment on two key variables: loss-making

²⁵ Indeed, we find in our survey that firms reporting higher barter prices in their revenues also have higher barter prices in their costs.

EXHIBIT 38



Building Institutions for Markets



THE WORLD BANK

erally left transfers quite stable. In fact, this stability makes transfers acceptable as collateral for provincial borrowing. The problem, however, is that the system is overly complex. For example, there is one main revenue-sharing pool plus several other tax-sharing pools. These factors affect the transparency of the system.

A difficulty with both methods of revenue sharing is that they can weaken governments' incentives to invest in tax collection capacity. If direct grants are based on actual revenue shortfalls, local governments have little reason to levy or collect local taxes, since the additional revenue will be offset by a reduction in grants from the center. In contrast, matching grants, which require local governments to commit their own resources to receive transfers, are less likely to have these perverse effects. Similarly, under tax-sharing systems, each level of government has weaker incentives to administer and enforce a shared tax because part of the revenues gained by improved administration must be shared with other levels of government. Each level of government has strong incentives to "free ride" on the others' tax collection efforts. This incentive problem can be mitigated when tax administration is efficient, technocratic, and free from political influences. But when the institutions of tax administration are weak and subject to political manipulation, tax sharing can succumb to these perverse incentives (box 5.8).

The incentive effects of revenue-sharing arrangements go much further than simply the effects on revenue collection discussed above. The design of revenue-sharing arrangements can also have important implications for how subnational levels of government use the economic policies at their disposal to foster market development. China and Russia's experience with intergovernmental fiscal relations illustrates the powerful effects of these incentives. In both China in the 1980s and Russia in the 1990s, substantial authority over local economic policies was delegated to subnational levels of government. Both countries also experienced declines in tax revenues relative to GDP, with a growing share of revenues and expenditures under the control of subnational levels of government.

Tax-sharing arrangements have had important incentive effects in both countries. In Russia a Law on Basic Principles of Taxation, specifying the assignment of taxes to different levels of government, was passed in 1991 but was not implemented consistently. In practice, the authority of different levels of government to levy taxes, and the rates at which revenues from shared

Box 5.7

Market discipline versus state discipline: municipal bankruptcy in Hungary

In 1996 Hungary adopted a law that established bankruptcy procedures for municipal governments. The objective of the law was to prevent municipalities from defaulting on their debt obligations by providing a clear set of rules to be followed in cases of financial distress. If a municipality falls behind in its debt service or other obligations, bankruptcy proceedings can be initiated either by creditors or by the municipality itself. The municipality then formulates an emergency budget covering mandated public services. It is prohibited from issuing new debt while it enters into negotiations with creditors. If all parties can reach a compromise debt workout agreement, it is implemented. If not, the case is turned over to the court system, which enjoys a constitutional guarantee of independence. The courts can then order liquidations of municipal assets to pay off creditors.

Since 1996 there have been nine cases of municipal bankruptcy, seven of which were resolved during 2000. Importantly, the central government has not provided financial assistance to any of the municipalities involved. This experience has served to strengthen the credibility of the central government's commitment not to bail out municipalities in financial distress. This in turn has helped to harden municipalities' budget constraints, as municipalities now face "market discipline" from their creditors, as well as "state discipline" in the form of monitoring and supervision by the central government. It is too soon to determine the ultimate effect of this institutional innovation. However, the fact that municipal debt service obligations are now well below centrally mandated ceilings is a promising sign.

Source: Wetzel and Papp 2001.

taxes were divided, were subject to continuous renegotiation, with the outcome reflecting shifting balances of political power.⁴⁹ Lower levels of governments that succeeded in raising local tax revenues often saw commensurate reductions in tax-sharing payments from higher levels. One study found that for some Russian cities, this reduction was almost exactly one for one.⁵⁰ The same study found that the extent to which local governments had control over incremental tax revenues mattered for local economic activity. The more that a city's incremental tax revenues were eroded by reduced transfers, the lower the rate of new business formation.

In China in the 1980s the central government set rates and defined the base for many taxes, but tax collection was delegated to provincial governments. Tax revenues were shared according to a "tax contracting"

distortion
intergovt
sharing
still in
effect

Box 5.8

Tax sharing with weak tax administration: the case of Russia

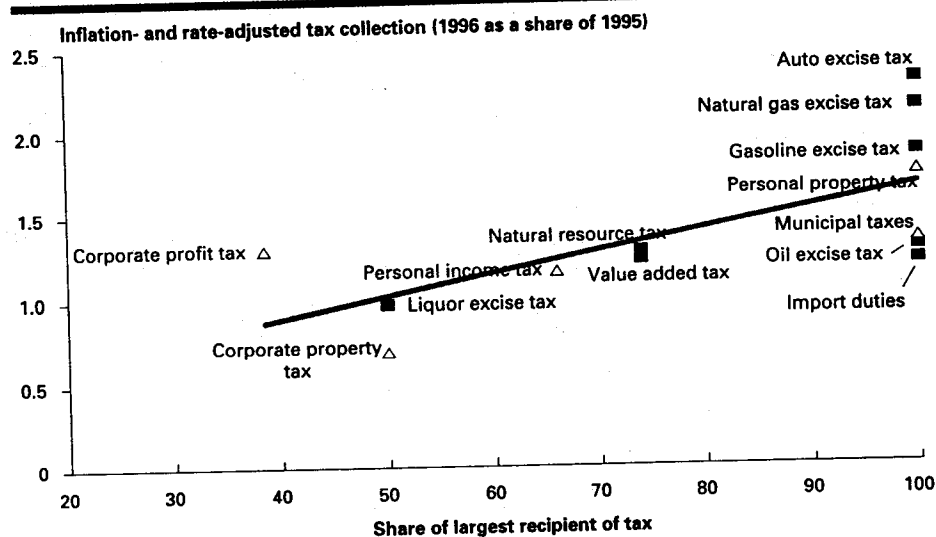
The case of Russia in the 1990s provides a vivid illustration of the perverse incentives created by tax sharing when tax administration is weak. In the 1990s Russia experienced a sharp decline in tax revenues, with federal tax revenues collapsing from 18 percent of GDP in 1992 to 10 percent of GDP in 1997.

A portion of this decline can be attributed to the overall poor performance of the Russian economy during this period and to declines in several key tax rates. Another factor was a decline in the effectiveness of tax administration, driven by competition between different levels of government. While in principle tax collection in Russia was a federal responsibility carried out by the State Tax Service, in practice local branches of this agency were heavily influenced by local governments. Local governments in turn tried to protect firms located in their jurisdictions from having to pay taxes to the federal government or simply lobbied for general tax relief for local firms, thus subverting tax administration. For example, firms would agree to pay their tax obligations "in kind" to local governments by providing goods or public services directly, so that cash payments that needed to be shared with higher levels of government were avoided. Another example was the vigorous and successful lobbying of the federal government for a reduction in the tax arrears of the truck manufacturer Kamaz undertaken by the president of Tatarstan, where Kamaz was located.

The federal government would also attempt to enforce collections at the expense of the local governments, again subverting tax administration. When the automobile manufacturer AvtoVAZ was threatened by bankruptcy proceedings by the federal government due to mounting tax arrears, it eventually came to an agreement to pay current taxes only to the federal government, with no mention of its delinquent obligations to the local government. More generally, all levels of government had weaker incentives to collect shared taxes precisely because a portion had to be shared with other levels.

The figure below illustrates more systematically the adverse consequences of this competition over tax revenues. While the effectiveness of tax collection in 1996 relative to 1995 (measured as the ratio of actual collections in the two years, adjusted for inflation and changes in rates) increased for almost all taxes, the increase was most pronounced for those taxes that were subject to the least revenue sharing. This case illustrates the importance of a competent and autonomous tax administration for limiting competition over tax revenues between levels of government that can subvert the entire process of tax collection. Wide-ranging reforms in the tax system since 1998 have reduced the complexity of the Russian tax system and have increased the transparency of revenue-sharing arrangements, representing important progress.

Shared taxes were less effectively collected in Russia

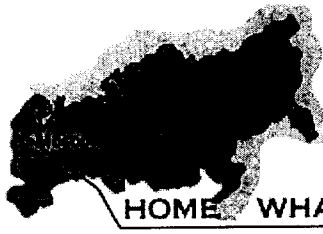


Note: Higher values on the vertical axis indicate improved tax collection effort.
Source: Treisman 1999.

system. Between 1985 and 1988 these contracts allowed provinces that ran deficits to retain a greater share of revenues, and provinces that ran surpluses a lower share. This weakened incentives to collect taxes, and revenue growth slowed in the richest provinces.

In response, between 1988 and 1993 the system was changed to give provincial governments greater claims over incremental tax revenues. For some provinces this amounted to an agreement to deliver a fixed sum to the center, with any additional revenues accruing to the

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From Predation to Prosperity: Breaking up Enterprise Network Socialism in Russia

Preface

This book is like a three-layer cake. One layer is Russia. Why did the purported market reforms, arguably the boldest in history, end up in one of the greatest peace-time economic contractions? Why, in addition, has Russia lived from one default to another—in fact, has lived off defaults? And, how can Russia be uplifted from contraction and defaults to economic growth and prosperity?

A second layer is socialism. In modern tradition, socialism is equated with big Government (with a capital G). But the Hobbesian jungle, in which predatory animals and predatory humans alike socialize the output of every person and every species by killing and stealing, is also socialism. On reflection, socialization, in the sense of predatory redistribution of output and income, with or without big Government, is socialism by definition. Predation, redistribution, and socialism are synonymous terms. Central planning, which took place under Communism (with a capital C), is only a special case of socialism with very big Government. This fact brings us back to Russia and to the question of its so-called market reforms and subsequent big contraction. Was Russia's transformation the result of market reforms or, in marked contrast, a mutation of socialism? This is a loaded question. It puts the economic philosophy of the last 300 years under siege. If what transpired in Russia was market reforms that resulted in a market economy, then the market system is not a universal road to prosperity. Indeed, it is not even universally viable.

We submit the case of socialist mutation in Russia in the 1990s. Russia mutated from socialism with big Government (with a capital G), or from Communism with a capital C, into a new, hitherto unknown species of socialism, without big Government. It mutated into communism with a lower-case 'c.' Moreover, for perhaps the first time in history, a second, parallel government emerged, which has the full power to tax the public and make the Central Bank print money. This parallel government is a network of enterprises. We will call this new economic species Enterprise Network Socialism, or ENS in short. This term helps to convey that the

Chapter 1

The Other Government: An Introduction to the Missing Facts

Can a country be less productive after Communism than under Communism? This question was unthinkable ten years ago and is unspeakable today. The past decade of Russian experience raises such a possibility. During 1990-99, Russia lost 45 percent of its gross domestic product (GDP) and about 50 percent of consumption.¹ This dwarfs the experience of the U.S. Great Depression when output declined by 30 percent and consumption fell by about 20 percent. Even during the extreme social experiment in the Soviet Union in the late 1920s-early 1930s, with its severe demographic losses, the economic decline was smaller than in the 1990s. In addition to protracted contraction, Russia underwent serial defaults during 1992-99. They peaked in August 1998 with what one may call the Great Default, when the government repudiated its domestic bonds. After that, periodic defaults on external debt occurred in 1999.²

Economic contraction of the 1990s was protracted and continuous. After a steep output decline during 1992-94, contraction slowed down in 1995-96 and reversed into a slight recovery in 1997, only to revert to another big slide in 1998. Part of the 1998 drop in GDP was recovered in 1999 and early 2000, but a pronounced decline in personal consumption continued through 1999. Many other post-Communist economies experienced great contractions. Their causes remain elusive after a decade of study.³

¹GDP: The International Monetary Fund, *World Economic Outlook*, October 1999 (Washington, D.C.: The IMF, 1999), p. 126, and *World Economic Outlook*, May 2000, pp. 27, 113. Consumption: Russian State Committee on Statistics (RSCS), various issues. Independent computations confirm the magnitudes found in the official data. See McKinsey Global Institute, "Unlocking Economic Growth in Russia" (Moscow: McKinsey & Co., 1999), available at <http://205.253.128.117/mgi/russian.htm>; and, Mark De Broeck and Vincent Koen, "The Great Contractions in Russia, the Baltics and the Other Countries of the Former Soviet Union: A View from the Supply Side," IMF Working Paper WP/00/32 (March 2000).

²From December 1998 to June 1999, Russia missed \$1.2 billion in payments on the previously restructured dollar-denominated bonds. In June 1999 and in early December 1999, it failed to pay \$963 million to the London Club of commercial creditors, and missed another \$550 billion payment in late December of that year. A series of multi-billion dollar reschedules with the Paris Club of government creditors and the London Club of commercial creditors in 1999 and 2000 saved them and Russia from a wholesale default on the total external debt.

³For an excellent evaluation of the causes of the Great Contraction across many post-Communist economies see Robert A. Mundell, "The Great Contractions in Transition Economies," in Mario I. Blejer and Marko Skreb, eds., *Macroeconomic Stabilization in Transition Economies* (Cambridge, England, and New York: Cambridge University Press, 1997), pp. 73-99. The term "Great Contraction" comes from this article and is now widely used. See Mark De Broeck and Vincent Koen, "The Great Contractions in Russia,..." The most extensive statistical investigation to-date attributes contraction in many post-Communist countries to the decrease of subsidized trade with Russia. See Andrew Berg, Eduardo Borensztein, Ranta Sahay, and Jeromin Zettelmeyer, "The Evolution of Output in Transition Economies:

The range of possible explanations and remedies relies on the experience of developing countries.⁴ If this approach was sufficient, Russia's Great Contraction and the Great Default could have been averted or at least predicted. At the very least, they would have been explained. Instead of looking for what is familiarly wrong, we will search for what is wrongly unfamiliar. This chapter introduces the facts missing in the conventional approach and lays out the groundwork for our book. It outlines how the network of enterprises, inherited and liberated from central planning, has taken over fiscal and monetary power. The enterprise network has become a parallel government. It redistributes all incomes in the economy and causes defaults and protracted contraction. The next chapters add detailed analysis and evidence.

The Missing Facts and the Key Empirical Relations

What is missing? What is missing is a number of core facts and an understanding of the core structure of the new Russian economy.

1. The Fake Budget

To start with, Russian fiscal accounts, the centerpiece of analysis and policy guidance by the Russian government, U.S. Treasury, the IMF, Western investors, and many Western researchers, are an obvious fake. Any apprentice accountant can tell this in a minute. To cite one example of many, tax offsets and Central Bank credit to enterprises for paying taxes should be added to budget expenditures or subtracted from tax revenues.⁵ Either way, they should be added to the budget deficit.⁶

Let us see how the Russian budget works. Suppose that one or more enterprises provide some

Explaining the Differences," IMF Working Paper WP/99/73 (July 1999). Even if this explanation was valid (we will show in Chapters 14 and 15 why it is not), it cannot apply to Russia and thus cannot be universal.

⁴For two overviews, see Dani Rodrik, "Understanding Economic Policy Reform," *The Journal of Economic Literature* 34, no. 1 (March 1996): 9-41 and Mathias Dewatripont and Gerard Roland, "Transition as a Process of Large-Scale Institutional Change," *Economics of Transition* 4, no. 1 (May 1996): 1-30. A most influential compendium of this approach is The World Bank, *From Plan to Market. World Development Report 1996* (New York: Oxford University Press for the World Bank, 1996). The latest summary is in Stanley Fischer and Ratna Sahay, "The Transition Economies After Ten Years", IMF Working Paper WP/00/30 (March 2000).

⁵Tax offsets are tax credits. The government allows enterprises to reduce their tax liability in the amount of the value of goods and services they rendered to government agencies, the military, non-profit organizations, and key industries. For a detailed description and data, see Brian Pinto et. al., "Dismantling Russia's Nonpayments System" (Moscow: The World Bank, September 1999). Separately, the Central Bank prints money and disburses it through the banking system as loans to enterprises, after which enterprises remit taxes to the government.

⁶The IMF lists several factors which affect the accuracy of reported budget deficits in post-Communist economies, but none of the above. See Stanley Fischer and Ratna Sahay, "The Transition Economies After Ten Years," p. 8.

goods or services to government organizations but don't receive payment. Or, perhaps an enterprise may be mandated by the government to supply another enterprise and, again, doesn't get paid. In exchange for delivery of goods and services, but for which payment was not received, the government forgives (offsets) the enterprises in question a commensurate amount of tax payments. The forgiveness of a tax liability, or a tax offset, enables enterprise to receive what they are due by retaining for themselves the equivalent amount in taxes they withheld from workers and collected from consumers, which otherwise they would (should) remit to the government in cash. These payments by government, tax offsets, represent government expenditure which is not recorded in the budget.

Suppose the government only counts cash flow as it treats the budget. Since the tax offset, the equivalent of government expenditure, was not paid in cash, there is no need to record it in a purely cash flow budget. But the tax revenues collected by the government were only partly received in cash, inasmuch as the offset amount was not received in cash. But the government lists the offset as part of revenues. The result is that either expenditures are understated if full accounting is made or revenues overstated in the case of cash flow accounting.

The same reasoning applies to Central Bank credit to enterprises through the banking system. Enterprises are given credits with which to pay taxes. If they did not receive this credit and did not pay the commensurate amount in taxes, recorded government revenues would have been smaller by this very amount. If enterprises were given a direct budget subsidy instead of Central Bank credit, recorded government expenditures would have been greater by this amount. To cover the budget deficit resulting from lower revenues or higher expenditures, the Central Bank could purchase government bonds and print money in the same amount, instead of giving credit to enterprises. Again, either expenditures are understated or revenues overstated.

Due to these and similar factors, the true budget deficit in Russia was 10 to 15 percentage points of GDP higher in various years than universally accepted. One can readily infer that Russia's fiscal house is unsustainable and that Russia must default every few years, which has been the pattern.

2. The Tax Subsidy

The next key fact follows directly. Russia runs a huge, off-budget subsidy to enterprises in the amount of 15-25 percent of annual GDP in various years.⁷ This subsidy is even more strange than it is huge. It is not like any of the variety of subsidies that we know through history and around the world. What unites all subsidies existing on record is that the government gives them, voluntarily or under pressure. Subsidies emanate from the government. In contrast, the subsidy in Russia is self-made. Enterprises collect taxes from consumers and workers on behalf of the government, as do firms in market economies, but do

⁷Chapter 9 presents detailed data on the bulk of this subsidy but cannot capture it in full.

not remit part of the revenue they collect to the government.⁸ They also receive Central Bank credit to increase remittance, which is a reshuffle of the same subsidy.⁹ This subsidy is directly taken by enterprises from the public, after which part of the take is exchanged with the government for Central Bank credit. Therefore, even the Central Bank part of the subsidy is not given by the government. The entire subsidy is not given, it is taken. It does not emanate from the government. It is collected as a tax and should be called the tax subsidy. Its simple essence is parallel taxation of the public by enterprises.

The network of enterprises acts as a parallel government, collecting revenues through the interplay of taxing the public and printing money. It follows that this second government co-owns the tax base and the Central Bank. The enterprise network is the other fiscal authority and has power over the monetary authority. Since the tax subsidy is off-budget and is self-collectible, and since enterprises decide how much of tax collection they give to the government, their subsidy determines the ultimate expenditure. They decide on the size of the budget deficit and debt, and they are the ultimate fiscal authority. The G-7 finance ministers and central bank governors are talking with the penultimate authority at meetings with their Russian counterparts.¹⁰

3. The Tax Subsidy is a New Phenomenon

The tax subsidy may look like some familiar off-budget subsidies. It may resemble bailouts and tax exemptions in Western market and developing economies and the soft budget constraint in central plan economies. The fundamental difference of the tax subsidy is that all other subsidies emanate from the government, whereas the tax subsidy is self-collected. In Western market and developing economies, firms

⁸The literature described part of this non-remittance under the name of tax arrears. See Mark E. Schaffer, "Government Subsidies to Enterprises in Central and Eastern Europe: Budgetary Subsidies and Tax Arrears," in David M.G. Newbery, ed., *Tax and Benefit Reform in Central and Eastern Europe* (London: Center for Economic Policy Research, 1995), pp. 115-144; Mark E. Schaffer, "Do Firms in Transition Economies Have Soft Budget Constraints? A Reconsideration of Concepts and Evidence," *Journal of Comparative Economics* 26, no. 1 (March 1998): 80-103; Michael S. Bernstam and Alvin Rabushka, *Fixing Russia's Banks* (Stanford, CA: Hoover Institution Press, 1998), pp. 29-34, 69-71; and, Brian Pinto et. al, "Dismantling Russia's Nonpayments System."

⁹The literature keenly calls the latter phenomenon a "quasi-fiscal subsidy." See G.A. (Sandy) Mackenzie, "The Hidden Government Deficit," *Finance and Development* 31, no. 4 (December 1994): 32-35 and The World Bank, *From Plan to Market*, pp. 35-36.

¹⁰To borrow a term from biology, one can call the relationship between enterprises and the government symbiotic, whereby the government is the symbiont. The term enterprise is a shortcut. James M. Buchanan taught all of us methodological individualism. See James M. Buchanan, *The Limits of Liberty: Between Anarchy and Leviathan* (Chicago: The University of Chicago Press, 1975). When we talk about enterprises, we mean their individual decision makers, such as owners and managers and, whenever applicable, workers. For clarity, we have chosen to use the term enterprise to denote productive units (even if money losing) in Communist and post-Communist economies, as opposed to market firms in Western market economies. We can also use the terms businesses and companies to describe market firms. When we need a generic term for both firms and enterprises, we will call them establishments.

obtain subsidies by lobbying the government and manipulating the political process¹¹ or receive bailouts because they are “too big to fail.”¹² The best known bailouts are those of the Chrysler Corporation in 1979, the Savings and Loan Associations in the 1980s, and numerous corporate and banking bailouts in Japan and other countries.

An example of the off-budget subsidy under central planning is the cash flow subsidy, known in the literature as the soft budget constraint.¹³ This is a peculiar subsidy. On first glance, it looks like a bailout in Western market and developing economies: The government automatically picks up the negative money balances of enterprises when they run into cash flow problems and cannot meet their payment obligations. Beneath the surface, however, this cash flow subsidy is a forced subsidy. It is imposed by the government on enterprises in order to enforce such key features of central planning as the forced production mix and mandated deliveries to designated buyers—in short, forced exchange. Without this cash flow subsidy to the buyers, the sellers would break free, reorient supplies to paying customers, and change their production mix, as they always try to do. This would destroy central planning. The soft budget constraint is not a subsidy bonanza, as it is portrayed in the literature; it is the ultimate enforcement of central planning. It is a coordination mechanism of central planning, a chain that ties together the gang production on the unified assembly line throughout the economy.

The tax subsidy in post-Communist economies is so unprecedented and incredible that the literature usually confuses it with the soft budget constraint.¹⁴ In reality, they are exact opposites. The soft budget constraint is the subsidy that the government wants and enterprises do not. The tax subsidy is the subsidy that enterprises want and the government does not. The tax subsidy is self-taken, collected by the enterprise network as the ultimate fiscal authority.

4. The Takeover of the Tax Base

¹¹The literature amply calls this phenomenon rent-seeking. The founding works on rent-seeking are Gordon Tullock, “The Welfare Costs of Tariffs, Monopolies and Theft,” *Western Economic Journal* 5, no. 2 (June 1967): 224-232; Anne O. Krueger, “The Political Economy of the Rent-Seeking Society,” *American Economic Review* 64, no. 3 (June 1974): 291-303; and, James M. Buchanan, Robert D. Tollison, and Gordon Tullock, eds., *Toward a Theory of the Rent-Seeking Society* (College Station: Texas A&M University, 1980). For recent developments see Robert D. Tollison and Roger D. Congleton, eds., *The Economic Analysis of Rent-Seeking* (Aldershot, England and Brookfield, Vermont: E. Elgar, 1995).

¹²George A. Akerlof and Paul M. Romer, “Looting: The Economic Underworld of Bankruptcy for Profit,” *Brookings Papers on Economic Activity* no. 2 (1993), pp. 1-73.

¹³Janos Kornai, “The Place of the Soft Budget Constraint Syndrome in Economic Theory,” *Journal of Comparative Economics* 26, no. 1 (March 1998): 11-17.

¹⁴E.g., The World Bank, *From Plan to Market*, p. 142; Mark E. Schaffer, “Do Firms in Transition Economies Have Soft Budget Constraints?”; and, Brian Pinto et. al., “Dismantling Russia’s Nonpayments System.”

What empowers enterprises? What enables them to exact the tax subsidy? The answer may, indeed should, sound incredible: Russian enterprises can bloc the flow of payments, shut down the economy, and deprive the government of the tax base. The flow of payments holds together any economy that uses money; the flow of tax revenues holds the government at power. If enterprises can create a payment crisis, they can seize the tax collection with impunity. The case of a payment crisis is exceptionally rare; the case of the takeover of the tax base borders on the impossible. Nevertheless this is the case which we find in Russia and similar countries.

Imagine if enterprises halt payments to each other for inputs. They simply stop paying bills, discard invoices, terminate supplies to non-paying customers, and switch to barter in the rest of the transactions. This would wipe out the tax base, which consists of payroll, personal income, and sales, all embodied in monied payments. What can the government do in this situation? Its options range from bad to worse. The government may try to borrow funds. But who would lend to a government that has lost its tax base and is unable to repay debt? The government can print money, but it would quickly run into hyperinflation in the absence of other sources of financing (taxes and debt). People would switch to dollars, abandon local currency altogether, and the government could not buy pencils and hire soldiers for rubles. No tax revenues, no borrowing, not much of a money printing option. The government would go out of commission.

Being on the brink of losing the tax base on the backdrop of a payment crisis is not a fantastic possibility. This has been the daily existence of the Russian government. Russia has been chronically on the edge of this scenario since January 1992 when central planning was abolished and enterprise transactions were decontrolled. Under central planning, the government helped enterprises pay their bills. Enterprises, however, were constrained in the amount of their invoices and bills by price controls which were linked to production targets. Once central planning was abolished and transactions and prices decontrolled, enterprises were free to charge each other and the government whatever amount of invoices they thought—perhaps initially hoped—would be paid. Either by sheer accident or design, a number of enterprise managers started to inflate their invoices as claims on public income to test if they would be paid. Once the results were known, everyone followed suit. Those who stayed on the sidelines lost out. By attrition, the remaining players were, through a new invisible hand, engaged in a seemingly coordinated raid on the public income through the mechanism of over-invoicing to get paid as much as they could.

With overcharging as the norm, enterprises create a traffic jam of payments throughout the economy, whereby it takes a buyer three-to-four months to pay an invoice to the seller, after which he can pay his own suppliers.¹⁵ A further increase in this jam of payments can grind the economy to a halt.

¹⁵Calculated from the data from the Russian State Committee on Statistics. Throughout this book, all data derives from the Russian State Committee on Statistics and the Central Bank of Russia, unless we specifically cite other sources. Most of this data is in the public domain. It appears in various printed annual, quarterly, monthly, and occasional publications of these two agencies. Much of this data is available on the Internet, in both English and Russian, at the following sites: <http://www.cbr.ru/>, <http://www.gks.ru/>, <http://www.rbs.ru/gks/>, and

Payments in the economy are like the air we breathe; a prolonged interruption is lethal. Payments embody exchange. Without payments, there is no exchange save small-time barter. Payments are the cash flow which lubricates the production flow. The traffic jam of payments is a cash flow jam. But the cash flow is fungible like liquid in pipes. As Gertrude Stein summed it up, “[m]oney is always there but the pockets change.” This is exactly the point. In the payment jam, on the edge of a complete stoppage of the traffic of cash flow, production flow, and tax flow, the pockets become fungible. Enterprises take the cash flow as needed from whatever is there. What is there is the taxes they have collected from the public for the government. Enterprises appropriate the cash flow from the tax base, pay their accumulating bills, keep the traffic of payments going, and thus preserve the rest of the tax base for the government.

5. In the Payment Jam

What is a traffic jam? People and horses knew it in the streets of London in the late 18th century, but hardly anywhere else. Now people know it in every corner of earth, with automobiles, rickshaws, and what not. The development of the information economy and home offices will retire this knowledge. Fifty years from now, if not earlier, only old folks will remember in the West what a traffic jam is, and they might not be able to relate it to others. One needs to be in it to know it. The same with the payment jam. Try telling it to those who have not been in it.

The traffic jam of payments is one of the most important, most confusing, and most ignored facts of life in Russia. This payment jam is peculiar to economies after central planning.¹⁶ All post-Communist economies experienced it to one or another extent, for a longer or shorter period. A small body of peripheral literature extensively documented and analyzed this phenomenon but did not explain its power. The literature calls this phenomenon a liquidity crisis (in the case of Yugoslavia of the 1960s and 1970s), non-payments (in the case of Russia), and arrears.¹⁷ The preponderant literature has long maintained that

<http://www.finmarket.ru/meconomic.asp/>. In addition, the Russian-European Center for Economic Policy collects from Russian official agencies and provides to the public an extensive, ten-year data set and monthly updates at <http://www.hhs.se/site/ret/ret.htm> and <http://www.hhs.se/site/ret/excelldb/default.htm>.

¹⁶Germany after the War Socialism of World War I and the Soviet Union in the 1920s-early 1930s, between the two episodes of central planning, saw this phenomenon. See Gerald D. Feldman, *The Great Disorder: Politics, Economics and Society in the German Inflation, 1914-1924* (New York and Oxford, U.K.: Oxford University Press, 1993); and, Paul Gregory and Aleksei Tikhonov, “Money, Credit, and Plan: Creating the Soviet Financial System,” Hoover Institution, Working Papers in International Studies, I-99-7 (October 1999).

¹⁷Laura D. Tyson, “Liquidity Crises in the Yugoslav Economy: An Alternative to Bankruptcy?” *Soviet Studies* 29, no. 2 (April 1977): 284-295; P.T. Knight, “Financial Discipline and Structural Adjustment in Yugoslavia: Rehabilitation and Bankruptcy of Loss-Making Enterprises,” World Bank Staff Working Papers, no. 705 (Washington, D.C.: The World Bank, 1984); Guillermo A. Calvo and Fabrizio Coricelli, “Credit Market Imperfections and Output Response in Previously Centrally Planned Economies,” in Gerard Caprio, David Folkerts-Landau, and Timothy D. Lane, eds., *Building Sound Finance in Emerging Market Economies* (Washington, D.C.: The International Monetary Fund and the World Bank, 1994), pp. 257-294; Guillermo A. Calvo and Fabrizio Coricelli, “Inter-Enterprise Arrears in Economies in Transition,” in Robert Holzmann, Janos Gacs, and George Winckler, eds., *Output Decline in Eastern Europe: Unavoidable, External*

EXHIBIT 40

Hitting the smallest the hardest

Metal Bulletin and Metal Bulletin Monthly published by Metal Bulletin Journals Ltd (a subsidiary of Metal Bulletin plc).

UK Editorial Office: 16 Lower Marsh, London SE1 7RJ. Tel: 0171-827 9977. Telex: 917706. Fax: 0171-928 6892 and 0171-827 6495.

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Advertising: Fax: 0171-827 5292. Advertisement Director: Neil Roberts; Sales Manager: Mark Homfray-Davies; Deputy Sales Manager: Wayne Mar; Sales Executives: Richard Parry, Melany Blauvelt; Advertisement Production: Lisa Vincent.

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Delegates at the annual Diggers and Dealers Forum warmly welcomed the comments by Western Australian Resources Development and Energy minister, Colin Barnett, when he officially opened the conference last week, for Barnett gave his thoughts on the hottest topic in the Australian mining industry — the proposed removal of the diesel fuel excise rebate.

Barnett described it as unjust, politically unwise, and an economic madness, and although the Western Australian government is backing the minerals industry to the hilt, unfortunately for the miners, the decision is not up to Barnett and his friends.

That decision will be made by August 20 when the federal treasurer Peter Costello hands down his budget. And although the federal government and the WA state government are on the same side of the political fence, they are poles apart on the diesel rebate issue.

The excise was introduced in 1958 with the levy earmarked entirely for new road construction. Given Australia's vast area and small population, the concept of a special levy in order to raise the status of the road system from that of a third world country to one more suitable to a modern nation, seemed to make sense.

The mining industry and the farming community were exempted on the

grounds that they did not use their vehicles on public roads. It was such a good idea, that the politicians progressively increased the level of the excise and conveniently forgot its original intention. Today, the income raised ends up in that great melting pot called General Revenue.

Unfortunately, that melting pot is too small. The recently-elected federal Prime Minister, John Howard, is con-

Dropping the rebate, which the industry describes as a refund of excess taxes paid and not a subsidy, will hit the small gold mining companies the hardest

stantly reminding the public of the handing down by the previous Labor government of a "A\$8bn black hole" in the budget. And Howard and Costello are determined to fill that hole quickly.

They believe that by cutting the "subsidy" to the mining industry it will go a long way to solving their budget problems. Prior to the March 2 election the Minerals Council of Australia was given a written guarantee by the then opposition that it would not drop the rebate if elected.

But politicians, it seems, only make election promises so that they can be broken and Australian politicians are as good at this as their overseas colleagues.

Reneging on their promise will hurt industry badly — to the tune of some A\$800m a year. The cost of fuel will rise from A\$0.28 cents a litre (already fairly high compared to Chile's A\$0.22) to a crippling A\$0.58 (see page 5).

BHP Minerals says that it will reduce its income from the Pilbara iron ore mines by A\$50m and MIM has calculated its bottom line profits will be about A\$30m less.

But dropping the rebate, which the industry describes as a refund of excess taxes paid and not a subsidy, will hit the small gold mining companies the hardest. Typically these produce around 15,000 oz/year from usually low grade open cut deposits.

Living on a shoestring the higher fuel cost will at best force them to high grade their mines thus sterilising recoverable reserves and at worst shut them down.

Their impact on the output of the Australian gold industry is relatively small, but collectively they employ thousands of people. The politicians may at this crucial time also ponder the suggestion that many large companies were at one stage struggling small miners.

Taxing times for Russia's steel mills

At a July 26 conference in London, Yegor Gaidar, leader of the political party, Russia's Democratic Choice, and the country's acting Prime Minister from June to December 1992, said that Boris Yeltsin's re-election as Russian president was a victory not for the man but for the introduction of a convertible currency, private property and market reforms.

Such discussions — focusing on Yeltsin himself and his victory over the communist Gennady Zyuganov rather than the policies of his government — amount to a post-election collective sigh of relief which tends to obscure the main economic issue at stake. Russia's coffers are bare after the elections and one way to fill them is to reduce tax arrears, a policy that will spell disaster for the country's steel mills, many of which are teetering on the verge of bankruptcy.

During May arrears to the federal budget increased by R2,300bn, bringing the total to R61,300bn of which some R23,100bn are deferrals under a presidential decree issued in January and generally agreed to be a pre-election sweetener. Commentators concur that key elements in the 1997 budget will be tax reforms along with measures to

reduce subsidies and break up bankrupt enterprises.

These predictions came in a week when the Russian Federation Committee on Metallurgy submitted proposals to the president suggesting tax cuts in the steel industry and the giant Zapsib steel mill asked for tax breaks and foreign investment to stave

Russia's coffers are bare after the elections and one way to fill them is to reduce tax arrears, a policy that will spell disaster for the country's steel mills

off bankruptcy. The recent collapse in the Far East market for long products has seen Russian mills having to drop prices as huge stocks pile up on the docks at Black Sea, Baltic and Russian Far East ports. Prices for semis and finished products have plummeted from January levels. Russia's mills and the Western traders involved in joint ventures with them are describing themselves as "bleeding our way through the crisis." In addition to this, energy and

freight costs are constantly rising and substantial modernisation is long overdue at the majority of plants. Last year's unpopular shares for loans auctions in which 15% packages of shares in Novolipetsk Iron and Steel Works, Zapsib and Mechel were sold for a fraction of their market price as collateral against the budget deficit did nothing to raise cash for future development.

Informed sources agree that steelworks are currently supposed to pay tax at around 50%. The Metallurgy Committee's proposal reduces this figure to 30% of turnover — 12% for the federal budget, 15% for the regional budget and 3% for local budgets. In reality, however, the tax system is full of loopholes, corruption and confusion. As one Western source put it, "Each of the mills has its own arrangement with the authorities." The implication is that most of Russia's cash-strapped steel plants pay minimal taxes, or none at all, and that moves to force payment would destroy them.

As long as Russia's steel producers need to rely on their continued enjoyment of tax benefits, their future under a government committed to reducing tax arrears will remain threatened.

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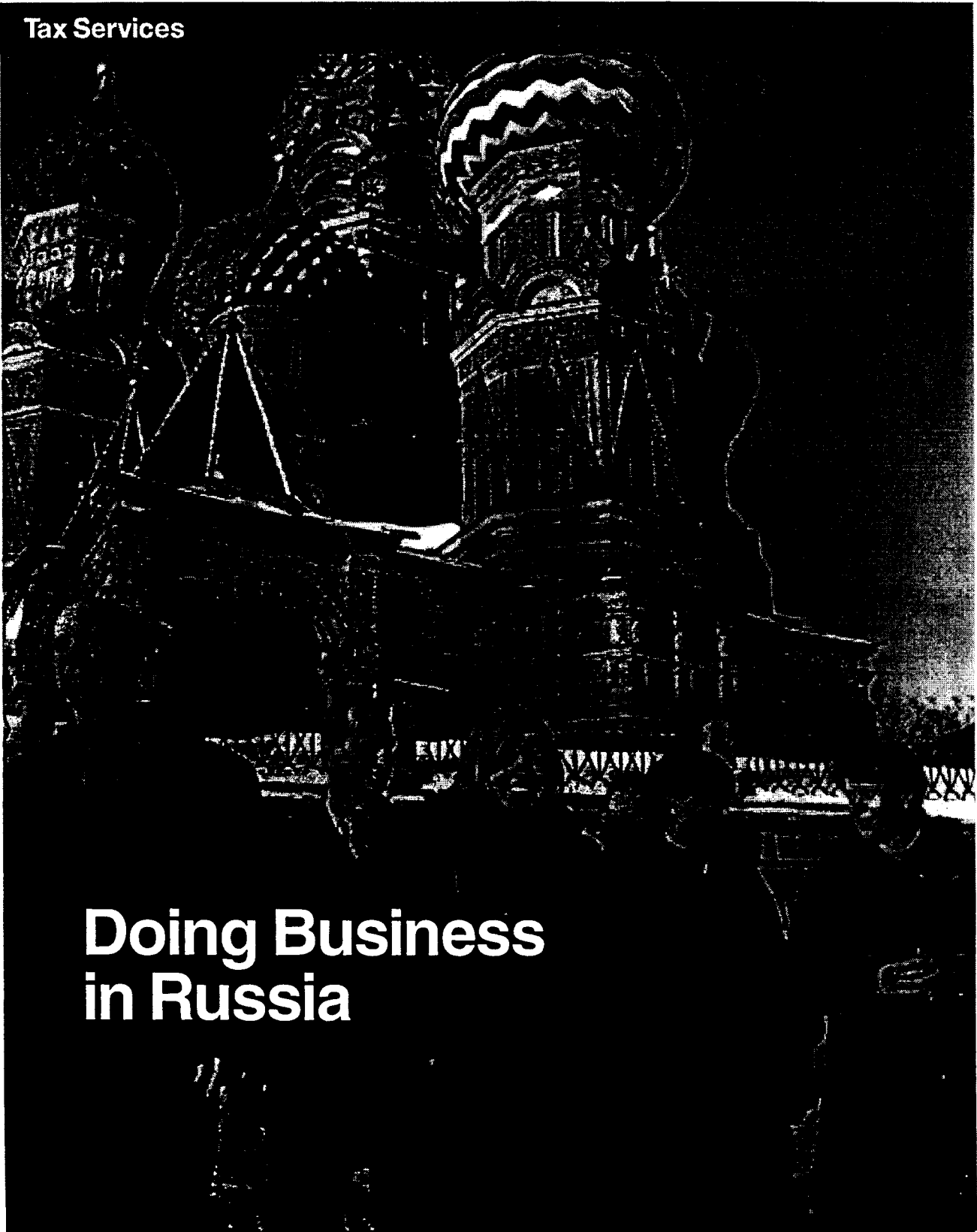
Registered as a Newspaper at the Post Office ISSN 0026-0533

EXHIBIT 41



ARTHUR ANDERSEN

Tax Services



**Doing Business
in Russia**

Taxation of businesses

Tax reform

Historically the Russian tax system has been characterised by a large number of taxes and levies, and complex tax laws, regulations and instructions that are often open to conflicting interpretations by the tax authorities. Furthermore the tax burden on business has been quite heavy (albeit recently certain attempts have been made to reduce it) whilst tax collection levels were poor due to systematic tax evasion by a significant proportion of taxpayers. The position of taxpayers has also historically been affected by harsh sanctions for non-compliance, although the sanctions that now apply under the new Tax Code represent a considerable improvement.

Reform of the Russian tax system has been on the legislative agenda for some time, although its progress has been slow. Tax reform in Russia is taking the form of the adoption of a comprehensive Tax Code that will substitute numerous individual laws governing particular taxes. Many drafts of the Code have been considered over the last few years, most of which were, thankfully, rejected. Due to fierce debates over the Tax Code in the Duma it was decided to pass it in piecemeal fashion. Part I of the Tax Code was adopted in the summer of 1998 and entered into force on 1 January 1999. Part I mainly covers administrative and procedural matters as well as establishing principles for the introduction of new taxes, protection of the rights of taxpayers and avoidance of tax discrimination. Part I currently provides that in cases of ambiguity of a tax law, the interpretation most favourable to the taxpayer should apply.

The year 2000 marked probably the most important stage of the tax reform thus far. Four chapters of Part II of the Tax Code covering VAT, excise tax, individual income tax and social tax were adopted and entered into force on 1 January 2001. The chapter on profits tax, which is considered the main element of tax reform, has not been adopted yet and hence is not expected to come into force until 1 January 2002. ✓

In addition, the Law "On Introduction of Part II of the Tax Code" was adopted effective 1 January 2001, which sets specific guidelines for application of the above four chapters and introduces transitional provisions from the old rules for certain aspects of Part II. It also puts forward limited changes to profits tax and turnover tax rules as an interim measure until the relevant chapters of the Tax Code are adopted. Chapters on property tax, production sharing agreements, etc. will also eventually replace the existing individual laws.

All Russian taxes must now be set out in the Tax Code and can be broken down into three main categories: federal, regional and municipal, depending on the level at which they are regulated.

It should be noted that while tax reform was generally intended to bring some relief from heavy tax liabilities and indeed some progress in this respect has been made through reductions in turnover taxes, abolition of some minor taxes (such as lubricants sales tax and car acquisition tax), the overall tax burden for businesses remains substantial. This is primarily because of the restrictive deductibility rules on profit tax and the existence of several indirect taxes (including VAT, property tax and turnover

EXHIBIT 42

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Document ID: CEP20010920000075

Entry Date: 09/20/2001

Version Number: 01

Region: Central Eurasia**Sub-Region: Russia****Country: Russia****Topic: DOMESTIC ECONOMIC, DOMESTIC POLITICAL, INTERNATIONAL ECONOMIC, INTERNATIONAL POLITICAL****Source-Date: 09/19/2001****Russia Seen To Be Making Slow Progress In WTO Talks***CEP20010920000075 Moscow Nezavisimaya Gazeta in Russian 19 Sep 01 P3*

[Report by Ivan Sas: "Russia is Disliked Because of Its 'Amber' Basket -- Our Country's Prospects For Joining The **WTO** Remain Hazy" -- Taken from the HTML version of source provided by ISP]

[FBIS Translated Text]

It would seem that Russia is beginning a new massed "assault" on the bureaucratic bastions of the World Trade Organization (**WTO**). After a bit of a lull, which was needed to sum up the results of the eight-year battle to join this international organization with full rights, the Russian delegation, headed by Deputy Minister for Trade and Economic Development Maksim Medvekoy, has again set out abroad - this time for Oslo. There, Russian officials are trying to "break through" the Scandinavians' traditional imperturbability in order to enlist the support of their Northern neighbours.

Since Russian President Vladimir Putin named joining the **WTO** as a priority in Russian foreign economic policy in his message to the Federal Assembly, it has become dangerous for Russian officials to return empty-handed from negotiations.

Russian submitted its application of intent to join the international trade organization in June 1993. However, the fateful decision has not been taken yet. Each time, this has been hindered by the tough position of the USA and the representatives of a number of other countries, which think that the situation in Russia is still too uncertain and the reforms ineffective. These Russian "failings" may change the world trade system, and not for the

better. It would seem that the most recent talks in Geneva, which ended in failure, provoked an extremely nervous reaction both in the Kremlin and on Krasnopresnenskaya Naberezhnaya. Prime Minister Mikhail Kasyanov directly addressed the world business elite at the European economic forum in Salzburg: he said this was complete discrimination, Russia was being set "completely unprecedented demands as conditions for joining". It must be said that this "cry from the heart" did not meet with great resonance amongst the world trade sharks. And there are not yet any grounds for hoping that after eight years of unsuccessful efforts, things will suddenly get moving fast and we will get to the finish line.

Aleksandr Pakhomov, an adviser to the Ministry for Economic Development, describing the situation, which has developed on the negotiations "front", noted that "there is already some understanding on 70 percent of the positions and altogether around 11,000 of them are being considered". However, he said, "it is getting more and more difficult to move forward in the negotiations". Positions remain, concerning the branches of the Russian economy, which are most sensitive to tariff policy. Moreover, once Russia has joined the **WTO**, its market will become open to the maximum and many branches of industry will not be able to withstand competition from foreign colleagues. The task is to protect the poorly developed sectors of the economy - an aim, which is virtually unachievable. Aleksandr Pakhomov is sure that each further concession by Russia in the negotiating process will be granted with great difficulty. Things are particularly bad with regard to agreeing positions on the agricultural sector. Our foreign partners in the negotiating process are demanding strict limitations on state support for the agrarian sector and on the subsidizing of agricultural exports, which is unacceptable for the Russian side given the almost complete disintegration of the domestic agricultural complex. There are particularly bitter "battles" under way with regard to discussion of the parameters for the so-called yellow, or amber, basket, which sums up all types of state support for agricultural producers. In particular, our foreign partners in the negotiations are demanding that Russia withdraw from practising forms of support for farmers such as preferential writing off of debts, acquiring fuels and lubricants at a discount etc.

It is obvious that one dead-end would be enough to ensure that the "talking to the interested parties" would be dragged out for another 10 years at least. Hopes that the US administration would look more favorably on Russia's aspiration to become a member of the **WTO** after the tragic events in America are quite shaky. The USA decides much in this organization but not everything - other members can block Russia joining the **WTO** for years.

Some analysts fear that in seeking to speed up the negotiating process, Russia will go down the path of making serious concessions to particularly insistent partners. And if these concessions reach a critical mass, that is if they exceed the advantages, which Russia could gain from **WTO membership**, joining this organization will lose all sense. Only the bitterness of defeat will remain of the many years of "negotiations war".

[Description of Source: Moscow Nezavisimaya Gazeta in Russian -- Daily Moscow newspaper aimed at an elite audience and controlled by Boris Berezovskiy.]

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EXHIBIT 43

[\[Go To Best Hit\]](#)

Unclassified



Document ID: CEP20010703000428

Entry Date: 07/03/2001

Version Number: 01

Region: Central Eurasia, West Europe**Sub-Region: Russia, West Europe****Country: Russia, Austria****Topic: INTERNATIONAL POLITICAL, INTERNATIONAL ECONOMIC, LEADER****Source-Date: 07/03/2001****Kasyanov says Russia not seeking EU membership***CEP20010703000428 Moscow ITAR-TASS in English 1817 GMT 3 Jul 01*

[FBIS Transcribed Text]

Russia not seeking **EU membership** - premier

Text of report in English by Russian news agency ITAR-TASS

Salzburg, 3 July: Russia is striving for togetherness with the European Union, but it will not apply for entry into the **EU** because, to a large extent, it is "the matter of formalities," Prime Minister Mikhail Kasyanov said on Tuesday.

He emphasized the "togetherness" term and said Russia was a country of 150m people and that term was more appropriate. Togetherness with the European Union is the striving and the strategic goal of Russia, Kasyanov said. He cited as an example Austria, which was in the process of entry into the **EU** for ten years. At first, it is necessary to attune laws and "principles of the functioning of our economies", the prime minister noted.

Russia "will intensify efforts in the European direction" and boost the formation of joint working groups, which will elaborate a concept of the common economic space of Russia and the European Union, he noted. The issues are closely inter-related with Russia's entry into the World Trade Organization, because the **EU** is very much concerned about the inflow of capital, services and labour force even from the countries which are candidates for entry to the European Union, he said.

Russia is seeking an equal part in the World Trade Organization, Kasyanov remarked. "It does not ask for privileges or any special terms in finances, commerce or investments," he said. "Russia will gain the benefits itself".

EXHIBIT 44

[\[Go To Best Hit\]](#)

Unclassified



Document ID: CEP20010703000265

Entry Date: 07/03/2001

Version Number: 01

Region: Central Eurasia, West Europe**Sub-Region: Russia, West Europe****Country: Russia, France****Topic: INTERNATIONAL POLITICAL, LEADER****Source-Date: 07/03/2001****French president advises Russia against seeking EU membership***CEP20010703000265 Moscow Ekho Moskvyy Radio in Russian 0455 GMT 3 Jul 01*

[FBIS Translated Excerpt]

French president advises Russia against seeking **EU membership**

French President Jacques Chirac has said Russia should not seek to join the European Union, but remain instead one of the poles of the world, alongside the USA and China. Answering questions on Russian radio, Chirac said he had advised President Putin against splitting the Security Council over sanctions against Iraq. Other topics of the interview included the situation in the Middle East, Chechnya, the freedom of press in Russia and decisions of French courts against Russian property abroad. The following are excerpts from report by Russian Ekho Moskvyy radio on 3 July. Subheadings have been inserted editorially.

[Presenter] It is 0855 in Moscow [0455 gmt]. Good morning. I am Aleksey Venediktov. The guest of the Ekho Moskvyy radio today is President Jacques Chirac of France. Good morning, Mr President.

[Chirac, in Russian] Good morning.

[Presenter] Mr President, first of all I would like to congratulate you on becoming doctor honoris causa of Moscow University. This must be pleasant news for you.

[Chirac, in French, with subsequent translation] This is more than pleasant. This is an emotional event and great honour for me. I know Moscow University for a long time and I am very proud to receive the title of doctor honoris causa.

Russia's debts

[Presenter] Mr President, we are passing from pleasant events to vexed questions. I wouldn't like to repeat your yesterday's news conference with President Putin, therefore I am going to ask you questions which have been put by our listeners. I am going to ask you what listeners, and not journalists, are interested in. One of the questions - they've come from Sevastopol and Samara - is following: Did you discuss with President Putin the conversion of the Russian debt into Russian enterprises' shares?

[Chirac] Russia has sent no official request for this, at least so far. But in the long run, this issue could be discussed. This is not a matter of France making a decision, a decision must be made collectively by the so-called Paris Club. But if the Russian side makes such a request we are prepared to study the issue.

Death penalty

[Presenter] Here is another question. The issue of re-introducing death penalty has emerged in Europe and Russia recently, in connection with international terrorism first of all. We know that in Russia many high-ranking state officials and the justice minister, as well as great writer Solzhenitsyn, are in favour of introducing death penalty in Russia. What could you tell these people, what are your personal feelings about the benefits or disadvantages of death penalty?

[Chirac] I would like to tell you first that death can never be regarded as a fair decision. In Europe, no European state is not going to reintroduce death penalty, at least I for my part am categorically against the idea.

Humanitarian case

[Presenter] One of the important things which has been damaging relations between Russia and France is the case of actress Natalya Zakharova, who was separated from her daughter. We know that this is a decision by the French legal system, but there is a humanitarian aspect in this case. Sometimes the law goes against humanitarian aspects, mother and daughter. You yourself are a grandfather, you have a small grandson. Could Mr President ease the situation in some way? Was this issue discussed at the meeting with Mr Putin?

[Chirac] Yes, it was discussed. We are paying great attention to what's happening to little Masha [Zakharova's daughter]. But France is a country of law. This question is being dealt with by the legal system. The judicial authorities are independent and the rights of Ms Zakharova are guaranteed, including the right to visit her daughter. Of course, I would like a legal decision to be issued as soon as possible and of course I want it to be in Masha's interests.

Russia and a Swiss company

[Presenter] Here is another issue which has damaged and continues to damage Russian-French relations. Again it concerns actions by the French legal system. This is a matter of the arrest of the Russian tallship Sedov on the request of Noga company, then the arrest of the Russian embassy's accounts and recently an incident in Le Bourget. Our listeners ask: why does this happen in France and not in other countries? Is there any hidden agenda of the French authorities here?

[Chirac] I think you are wrong in this respect. The existing conflict is between the Swiss company Noga and Russia. France has nothing to do with this story. The Swiss company made certain steps. As it happens, this concerns France. It could have happened in a

different country. The company made steps to arrest Russia's property. We did everything possible to settle the problem. Sedov was able to leave Brest. We managed to avoid serious problems in Le Bourget. We greatly regret the story but there is no hidden agenda here on the part of France. France is not a side in this conflict.

Presidential elections

[Presenter] Here is an interesting question. You are flying to Samara today. Here is a question from Leonid from Samara. Are you prepared to win the presidential elections in 2002? Are you prepared for a victory? People in Samara are very interested in this.

[Chirac] I would like to thank listeners in Samara for their interest to the internal political situation in France and for the interest in my career. I can tell you that I never touch on internal political problems when I am abroad. But if your listener was so kind as to put this question to me, I will give him a very simple answer: the question is slightly premature and I will announce my intentions in due course.

[Presenter] I'm afraid you will be asked the same question in Samara, Mr President.

[Chirac] I will give the same answer.

Freedom of speech

[Presenter] Speaking in front of Moscow University students yesterday and listing the values which you deem very important for Russia, you put the freedom of speech and freedom of press in the first place. People in our country don't quite understand why. There are more important thing: the right to work, economic stability, the country's independence and sovereignty. Why freedoms? Why personal freedoms, why the freedom of speech, the freedom of press?

[Chirac] In the end of the 20th century, it became obvious that only a democratic society meets the interests and wishes of the people of the world, as well as the need for social progress and economic development. No-one argues with this anymore. However, it is impossible to create a democratic society without guarantees for the freedom of speech and, consequently, the freedom of press. That's why we pay great attention to everything which poses a threat to the freedom of press or the progress of the whole world, including Russia, towards democracy.

Milosevic's handover to The Hague

[Presenter] I remind our listeners that here is President Jacques Chirac live on air. I remind you that you can send your questions on our pager 9742222 for Ekho Moskv. There have been a lot of questions and they are still coming on the pager and our Internet site. Your position on the handover of Mr Milosevic is not very clear. Our listeners followed your yesterday's news conference with great attention and I pass their question to you: Please explain why the handover of Milosevic is the triumph of democracy over tyranny and of the law over violence, as you said. How does it help?

[Chirac] In the 20th century, and earlier centuries, we can see that unfortunately in some countries some tyrants imposed their will against the interests of people, sometimes putting the lives of the people in their countries in danger. This is inadmissible of course. Milosevic was just this type of tyrant. He is responsible for hundreds of thousands of lives, for the most difficult conditions of life and death of his fellow countrymen. This morning I saw on television the horrible consequences of Milosevic's rule. Therefore, it was important to bring him to book and make his answer for his crimes in front of an independent international

court. It was also important that the world community understand that it is no longer possible to mistreat people with impunity. I think this may stop someone who would try to follow Milosevic's example in other countries.

[Presenter] In your opinion, why didn't President Putin accept your stance? In what aspects do you differ?

[Chirac] Indeed, our stances are not exactly the same. Indeed, President Putin is concerned about stability in Serbia and, in a broader sense, about stability in the Balkans, because these aspects are connected. I understand his approach but don't share it completely. I think that the future of the Federal Republic of Yugoslavia will be built on democratic values and human rights, and not on the values of the past.

Sanctions against Iraq

[Presenter] Prior to your visit, the question of the similar attitude of Russia and France towards the sanctions against Iraq was discussed. The Security Council will discuss the matter today. Did you manage to persuade President Putin that the permanent members of the Security Council must adopt a joint position? Will France vote for the resolution put forward by the Americans and the British today?

[Chirac] President Putin and I share a view that it is necessary to open Iraq's borders wider and thus ease the suffering of its people, who have become accidental victims of tyranny, the Iraqi authorities' tyranny. The Iraqi authorities pose a lot of danger to the region. We believe it is necessary to follow the path at the end of which the sanctions will be lifted. But I think there are nuances between the West's position and that of Russia, if only for the simple reason that Iraq has considerable debts to Russia. I told President Putin that from my point of view it was not advisable to split the Security Council in two over Iraq. If we can't reach an agreement on a single document, it's better to postpone a final decision. I think this is what's going to happen in the end.

[Presenter] Yes, I think a US State Department representative said today that it's better to leave everything as it is since they could not reach an agreement. You are right, Mr President.

Russian and European Union, Nato

Here is another question. Yesterday Russian Prime Minister Kasyanov said in Salzburg that Russia is nearly ready to join the European Union. Do you think we are ready?

[Chirac] I've always, for a long time, spoken about a multipolar world, a world which would bring about a more perfect balance between different parts of the globe, in which every country, with its values and special traits, will be respected. In this context, it is obvious that the European Union is one of the poles, just as China, the USA, as Latin America may become tomorrow, and as Russia, of course. Russia is a huge pole, from the historical, geographical and political point of view. Relations between the European Union and Russia must become more and more integrated, but at the same time I don't think one can imagine that Russia is about to join the European Union. I don't think this is where its goal and destiny lie.

[Presenter] What about Russia's **membership** in Nato then?

[Chirac] This is a completely different problem. It's important to reject old stereotypes and prejudices in the defence sphere. Nato has never been an aggressive union. It has always been a defence alliance. Of course, Nato is changing following changes in the world, including Russia. I was the first to put forward the idea of partnership relations between Russia and Nato and this decision was adopted later. Such partnership relations must be

improved of course and this is what we are doing.

[Presenter] We know that President Putin and Russia in general are strongly against Nato's expansion towards the territory of the former Soviet Union, the Baltic states. What is your stance on Nato's eastward expansion?

[Chirac] First I would like to say that one should not create new fault lines on our continent. We suffered greatly from fault lines which existed during the Cold War period. Taking into account that Nato is a defence alliance, I don't think it poses any threat. A whole series of countries outside Nato, including the Baltic states, would like to join the organization. But you know, there is a principle in international law which says that each country has a right to join any alliance or any organization. Therefore, I can't imagine how one can forbid a country to apply this principle.

Chechnya

[Presenter] Today one of the French papers, I don't quite remember which one, either Liberation or Le Figaro, wrote that France has diplomatically closed the Chechen page and practically did not touch the situation in Chechnya, or paid just token attention to it. Is this correct, Mr President?

[Chirac] I think this information is not correct. Every time when I had an opportunity to meet President Putin - when he came to France, to Sweden, where he took part in a European Union summit, in St Petersburg and Moscow yesterday and today - I had an opportunity to discuss the issue of Chechnya with him. First, I wanted to know his point of view, I wanted to know the reasons behind Russia's policy in Chechnya. However, I have always told him and reaffirmed that France, which knew such problems in the past and went through such problems, is confident that such problems cannot be resolved by military methods and that attempts to find a military solution always lead to woeful results, even if a country's leaders don't want it. Therefore, one should look for a political solution first of all, I told President Putin during our meetings several days ago.

The euro

[President] Here is another question, maybe a bit strange. Was it easy for you personally to reject the francs in favour of the euro?

[Chirac] No. With all my respect for the franc, of course, a single economic system has developed in Europe and differences in currencies affected negatively the development of the economy and society. I will cite you one example. When one European country had economic problems, the country announced devaluation of its currency. This often caused dramatic consequences in neighbouring countries. Tomorrow we will introduce a single currency and all these drawbacks, all these problems will disappear. This is a wonderful tool to develop trade turnover within the European Union and with the rest of the world. This is a great positive moment, a great additional force for the European Union. I am very happy that tomorrow we are switching to the euro.

Middle East

[Presenter] Here are three short questions in the end of our conversation. Can I continue? Great. The president is making signs that I may continue. You are in Moscow between two visits: one of them was earlier, a visit to Paris by the Syrian president, and after the Moscow visit you will receive the Israeli prime minister. What can you tell - [change of thought] Did you discuss with Putin the situation in the Middle East, in Israel, in Palestine? Do you see

any solution to this situation in the near future?

[Chirac] Yes, we discussed the problem in great detail with President Putin. One should not forget that Russia is a cosponsor of the peace process in the Middle East. During a certain period of time the US adopted a position according to which it was the only mediator in the search for a solution to the problem. At present it is obvious that the problem is difficult, that the world community must pull its efforts to find a peaceful solution, therefore the participation of the European Union and Russia is very important. We, Russia and France, share this approach, we believe that it is necessary first of all to ensure that terrorist acts and military actions stop. It is necessary to ensure at least minimal security, if possible, and on this basis return to the negotiating table, on the basis of the Mitchell commission's report, which would make it possible to resume dialogue between Israel and the Palestinians and maybe there will appear a glimpse of hope for the restoration of peace, to which we were so close six months ago...

Greetings to listeners

[Presenter] Mr President, you have one minute to address our listeners. What would you like to tell Ekho Moskvvy listeners and Russian citizens? You can speak to them now.

[Chirac] I would like to tell the Muscovites and Russian citizens the following. First, I very much like the Russian people, I admire them, their history, culture and feelings. I would like to wish this great people to regain a worthy and deserved place on the international arena. I would like to wish them to take this place next to the European Union, so that the European Union and Russia can contribute jointly to the strengthening of democracy, social progress and, of course, peace, so that political initiatives and political divergence do not lead to political confrontation of the peoples. Let this confrontation show itself in the realm of ideas. Let's defend our uniqueness by words, not by weapons. I would like to greet from the bottom of my heart the Russian people, the Russian youth, whom I trust.

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EXHIBIT 45

[Go To Best Hit]

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Document ID: CEP20011025000332

Entry Date: 10/25/2001

Version Number: 01

Region: Central Eurasia**Sub-Region: Russia****Country: Russia****Topic: CRIME, DOMESTIC ECONOMIC, INTERNATIONAL ECONOMIC****Source-Date: 10/25/2001****Report Alleges Corruption of Customs Organizations***CEP20011025000332 Moscow Novyye Izvestiya in Russian 25 Oct 01*

[Article by Sergey Sokolov, Federal Investigative Agency correspondent, on special assignment for Novyye Izvestiya: "Completely Transparent Borders for Weapons and Contraband" -- taken from HTML version of source provided by ISP]

[FBIS Translated Text]

After Prosecutor Aleksandr Murzin wrote an honest report on corruption in the customs service, officials of the RF State Customs Committee did everything within their power to take him off the case.

"The **foreign trade** businesses in the Moscow region today are completely criminalized. They are owned by various crime gangs, whose members include ... personnel of the customs service." "We can safely say that all of the lawlessness in the customs sphere was contrived and consciously supported by a certain segment of the so-called elite of our state and is intended to enrich it with no possibility of punishment." "A customs police force should be set up in the customs sphere as an entity separate from the customs service." These are excerpts from the report of Aleksandr Murzin, the former chief of the Tax Law Enforcement Oversight Office of the RF Procuracy General. The report was submitted to Prosecutor General Vladimir Ustinov in December 2000. The leaders of the RF GTK [State Customs Committee] were so shocked by the prosecutor's statements about the rampant corruption in the Customs Committee that even Prosecutor General Ustinov could not take any steps to continue the investigation. The customs service was incensed and started invoking all of its contacts in the upper echelon, and the Procuracy General had to retreat temporarily. Prosecutor Murzin was taken off the case and was

transferred to another, less "controversial" field of investigation. Murzin's unembellished and legally sound report, which the editors received from journalists of the FLB.RU Federal Investigative Agency, is worth reading for one reason. It explains why the leaders of the GTK are replaced regularly, but the corruption in the customs service persists. An efficient family system of enrichment at the state's expense has been established in this sphere, and everyone knows that the mafia is immortal.

An Analysis of the Practice of Procuracy Oversight of Law Enforcement in the Customs Sphere in the Moscow Region and Proposals for Its Reinforcement:

The money collected by the customs service now represents just under 40 percent of state budget income. Customs operations, however, still have not been given the necessary scrutiny by the government and law enforcement agencies.

The practice of procuracy oversight of the enforcement of customs legislation, the investigations of **criminal** cases of that category, and personal communications with customs personnel and the executives of commercial firms indicate that the sphere of **foreign trade** operations in our state is essentially a sphere of **criminal** business, undermining the security of the country and inflicting colossal financial and moral damages on the state.

The sphere is managed by various crime gangs, made up of individuals directly engaged in commerce and personnel of the customs service, MVD [Ministry of Internal Affairs], FSB [Federal Security Service], and other law enforcement agencies, who render various services for the gangs within the confines of their professional authority. Their colossal "illegal cash flow" provides unlimited opportunities to bribe officials of the customs service and other law enforcement agencies and to criminalize that whole sphere of operations and the related law enforcement system. As a result, about half of the customs fees due are never paid.

The most dangerous aspect of this is the absence of any kind of control over items brought into this country in external and internal customs offices. In other words, the borders are completely transparent not only for imports of substandard goods, but also for weapons, illegal drugs, etc.

The methods of illegally evading the payment of customs fees can be classified as follows, in order of the relative harm they cause:

CONTRABAND: This is the most harmful method as far as the economic security and physical safety of the country are concerned. This practice consists in acquiring goods abroad and bringing them into Russia through so-called "windows" on the border by prior arrangement with border guards and customs personnel, or delivering them to the consumer's storage facility within the territory of the Russian Federation, usually with an MVD escort, bypassing customs inspections and the processing of customs declarations.

NONDELIVERY: The goods are acquired abroad in the name of a shell company, are inspected by customs personnel when they cross the border, and are then sold within the territory of the Russian Federation without any internal customs classification procedures.

The situation can vary somewhat if the goods are delivered in line with the customs

convention on international freightage, using an MDP [international highway freightage] log. The freight carrier is financially liable for the delivery and will not sign the freight over to the consignee without the necessary internal customs documents. Under these circumstances, the consignees, by prior agreement with customs personnel, meet the driver at the temporary storage facility, collect the documents required for customs clearance from him, alter them to record the driver's delivery of the goods to a customs inspector, collect the freight from him, and sell the goods without paying any customs fees. The driver, who knows that they are breaking the law, is paid from \$2,000 to \$4,000, depending on the category of goods delivered, for his silence and his agreement to hand over the goods.

UNDERSTATEMENT OF CUSTOMS VALUE: In this case, the value of the goods is understated during internal customs formalities by submitting a false purchasing contract or a phony bill of sale.

FALSE DECLARATION: The customs fees payable are reduced by means of the substitution or alteration of internal customs documents containing information about the quantity or type of goods, and the goods are released, by prior arrangement with customs personnel, for free circulation without any scrutiny of the forged documents.

The participants in these **criminal** actions are, as a rule, the personnel of the temporary storage facilities and their satellite shell companies, as well as customs personnel on various levels.

These infractions are committed in the following manner:

A temporary storage facility is set up with the support of officials of the State Customs Committee and the Central Customs Administration. Several shell companies are set up for the avoidance of future administrative and **criminal** liability. These firms usually operate for two or three months as the consignors of freight sent abroad and consignees of freight entering Russia. These firms are the links connecting the actual shippers and recipients of the freight in the following chain: actual freight consignor (or owner)--consignor's shell company--consignee's shell company--actual freight consignee. Shell companies, usually set up by the owners of the temporary storage facility, therefore handle all contacts with the carrier, customs agencies abroad, and internal customs.

When the goods reach the storage facility (internal customs territory), its personnel substitute or alter the shipping documents to record goods eligible for lower customs duties. The warehouse personnel then submit those documents to the OTOTK (customs clearance and customs inspection division), usually located within the same temporary storage facility.

The OTOTK, made up of trusted customs personnel who generally collect bribes openly from the warehouse managers, not only fails to perform its official duties, but also conceals the **criminal** activity of the temporary facility. The OTOTK personnel clear the goods without inspecting them or verifying the information on customs declaration forms. In the event of possible **criminal** proceedings in connection with a false declaration or violations of customs regulations, the necessary documents are frequently destroyed.

According to procuracy records, the temporary storage facilities pay the customs personnel clearing the falsely declared goods from \$50 to \$100 for each false declaration.

The total amount of unpaid customs fees as a result of this practice can be judged by calculating the unpaid fees for imported meat products.

Each participant in **foreign** economic operations has approximately the same expenses on deliveries (the purchase price, the internal customs declaration fees, and shipping costs). The customs clearance fees for a single vehicle carrying meat products (this is usually a single GTD--customs freight declaration) weighing 20-23 tonnes in a conventional, "honest," clearance operation total \$6,000-10,000 depending on the product category. In the previously described **criminal** arrangement, the temporary storage facilities handle the clearance formalities for \$4,000, receiving from \$800 to \$1,000 in cash from the client for this service. The state can lose up to \$5,000 on each vehicle cleared in this manner.

The situation is similar for other high-duty goods: furniture, office equipment, and electronics. The state loses from \$10,000 to \$25,000 on each vehicle (each GTD) in these cases.

Incidentally, these simple mathematical calculations clearly refute the opinion, which is so common in the customs sphere and is so zealously perpetuated by customs personnel and by businessmen, that excessively high customs fees are to blame for everything, because their payment would make the sale of imported goods unprofitable in our domestic market.

The calculations indicate that the value of 23 tonnes of meat products for which all customs fees had been paid would be increased by \$5,000 (the amount not paid to the state). In other words, the price of a single kilogram would be increased by 5.8 rubles ($5,000:23,000=21$ cents, $21 \times 2.8=5.8$ rubles). Given the average price of 40-100 rubles per kilogram of meat products, this is not a substantial increase.

The possibility of prosecution in these cases, however, is virtually nonexistent: The companies declaring the goods do not exist, and the guilt of the customs personnel involved in the clearance operations cannot be established because the freight is gone, and it would be extremely difficult to refute their allegations that they did their duty, did not notice the forgery, and the freight must have been swapped en route.

Causes of the Current State of Affairs

According to customs officials, all of these problems are caused by the low wages of their personnel, the general rise in the crime rate throughout the country, and unsatisfactory laws. The crime rate in the country is high, of course, but the customs service, in contrast to other law enforcement agencies, such as the procuracy, MVD, and FSB, has not only failed to fight crime, but is actually nurturing crime with its own resources.

The discussion of laws, wages, and the national crime rate is irrelevant. They are not the main causes. The causes of what we have seen in the customs sphere can be divided into "political and technical" factors. The first include the lack of any determination on the part of the state to restore even the most rudimentary order in the customs service. We can safely say that all of the lawlessness in the sphere of **foreign** economic operations, and in the customs sphere in particular, was contrived and consciously supported by a certain segment of the so-called "elite" of our state and is intended to enrich it with no

possibility of punishment. The "technical" causes include the absence of any real law enforcement activity in the customs service for the genuine detection and prevention of crimes and other infractions and, as a result, the ability of individuals to commit those acts with virtually total impunity.

This is now the function of the so-called law enforcement unit of the customs service, responsible for undercover investigations and the administrative and **criminal** prosecution of individuals and firms committing customs violations.

The experience of procuracy oversight and joint operations with that organization have provided reliable evidence of its absolute inadequacy, its incompetence, and--what is most important--its lack of incentive to perform its official duties.

Law enforcement activity is now a sideline for the customs service rather than its main occupation. Its main purpose is fiscal--the collection of money for the budget. The results of that function serve as the basis for evaluations of its performance, for the praise or criticism of customs officials, for competitive awards and for personnel transfers. These are the results the Chairman of the GTK reports at meetings with the government and in personal conversations with the president, proudly declaring that customs personnel performing their difficult job provide the state with 40 percent of its budget income.

Apropos of this, it should be pointed out that customs personnel do not contribute anything to the national budget themselves. They simply transfer the money other people contribute to the budget, and they steal at least half of that money in the process.

It would be naive to expect any real action from the law enforcement units of the customs service and the Central Customs Administration under these conditions. They were installed, from the very start, not to fight against customs violations, but to conceal them, so that the customs service's dirty linen will never be aired in public.

Meanwhile, during just one operation to verify the information in the customs declarations of goods released for free circulation at the Tekhnobest-M temporary storage facility, by means of a second inspection on the grounds of the facility, conducted in the beginning of August by the Moscow-Kursk transport procuracy in conjunction with the regional division of rail transport internal forces, goods listed on eight GTD's, with a total worth of close to \$500,000, were impounded and confiscated as state income, **criminal** proceedings were instituted on the basis of sections 194 and 327 of the RF **Criminal** Code, the guilty parties were identified, two customs inspectors were prosecuted, and more leads are still being followed.

In summation, I would recommend that the procuracy take the following actions to stabilize the situation in the customs sphere:

An independent audit of the economic and law enforcement activity of the State Customs Committee, starting with the Central Customs Administration, must be ordered for the purpose of establishing the actual state of affairs. The amount of income the customs service should have collected in relation to the amount actually transferred to the budget must be determined.... Proposals must be submitted to the RF Government on organizational changes in customs agencies. They should perform only their fiscal function and the function of guarding customs borders. A customs police force, with the same

functions and staff positions as the present law enforcement unit of the customs service, should be set up to enforce the law in the customs sphere, but as an entity separate from the customs service.

[Description of Source: Moscow Novyye Izvestiya in Russian -- daily newspaper established by Boris Berezovskiy in 1997 as a counter to Izvestiya]

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EXHIBIT 46

[\[Go To Best Hit\]](#)*Unclassified*

Document ID: CEP20010808000191

Entry Date: 08/08/2001

Version Number: 01

Region: Central Eurasia**Sub-Region: Russia****Country: Russia****Topic: CRIME, DOMESTIC POLITICAL, DOMESTIC ECONOMIC****Source-Date: 08/08/2001****Russian Interior Minister: Many businesses under criminal control***CEP20010808000191 Moscow ITAR-TASS in English 1409 GMT 8 Aug 01***[FBIS Transcribed Text]**Many Russian businesses under **criminal** control - Interior Minister

Text of report in English by Russian news agency ITAR-TASS

Moscow, 7 August: Russian Interior Minister Boris Gryzlov on Wednesday announced the much-needed reorganization of the Russian police structures responsible for combating **criminal** activities in the country.

The minister declared that he had signed an order dissolving the federal **criminal** police committees operating in the federal constituents and in the regional departments in charge of combating organized crime.

He explained the move by pointing out, "We do not see today any real effects of their work, the work of the service which must fight organized crime. The clear-up rate of the crimes committed by organized groups, especially in the economic sphere, is not sufficient." "The figures reporting the number of detentions and investigations do not reveal any general policy line, do not show that the regional departments in charge of combating organized crime are fully informed about the situation which emerges, for instance, in the Northwestern Federal District, where the struggle against organized crime is a particularly acute problem."

The minister stressed that the Archangel, **Kaliningrad**, Murmansk and St Petersburg sea trading ports were 80 per cent controlled by organized **criminal** groups, as were many light, food, and processing industrial enterprises in St Petersburg itself and timber exports and tobacco and alcohol imports in Northwestern Russia. According to the minister, organized

criminal groups were trying to gain control over trade in petroleum products and over the fuel and energy sector.

In St Petersburg, the minister said, the so-called "Tambov" **criminal** group is in control of up to 100 per cent of industrial enterprises. It is impossible "to put up with this situation", the minister said.

He noted that it was baffling that a number of notorious contract murders have remained unsolved and none of the ring leaders or members has been brought to book in Northwestern Russia in the past 12 months.

To improve the crime-fighting activity in the region, a new chief was named to head the newly-formed Northwestern Internal Affairs department. Boris Gryzlov said Major-General Boris Uemlyanin who is appointed to the post by presidential decree has risen through the ranks of the police service from a precinct inspector to the regional police department head in Archangel Region, which he had headed until recently. Uemlyanin had graduated from the Interior Ministry Academy and had served in Afghanistan.

"In a month's time the Northwestern Federal District's Internal Affairs department must work at full throttle," Minister Gryzlov said in ushering in the new department head at a closed-door meeting in St Petersburg on Wednesday.

As far as the **criminal** situation in Russia as a whole is concerned, the minister pointed to "the situation with illicit drug trafficking" which he described as "catastrophic". "It is already reaching the level of posing a threat to national security," Gryzlov pointed out.

He expressed the hope that the **criminals** would soon feel the effects of the reorganization. He also expressed confidence that those who had set off a bomb explosion in Moscow's Pushkin square a year ago today will be found.

The Russian president is personally in control of the investigation into that act of terror which killed seven people on the spot, Six other persons died of the wounds in hospitals later, and 118 people, including six children, suffered from wounds inflicted by the explosion.

[Description of Source: Moscow ITAR-TASS in English -- main government information agency]

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EXHIBIT 47

[Go To Best Hit]

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Document ID: CEP20010824000138

Entry Date: 08/24/2001

Version Number: 01

Region: Central Eurasia**Sub-Region: Russia****Country: Russia****Topic: DOMESTIC ECONOMIC****Source-Date: 08/24/2001****Details of Scandal in Novorossiysk Port Administration***CEP20010824000138 Moscow Rossiyskaya Gazeta in Russian 24 Aug 01 P13*

[Article by Ilya Pavlov: "And the Wharves Sail Away Like Ships"]

[FBIS Translated Text]

Even court decisions cannot restore them to state property.

Over the last nine months three conferences have taken place already in the Southern Federal District on problems of the maritime commercial **trade** complex. Such attention toward it is not by chance. The southern ports are powerful economic structures. Almost half of Russia's **foreign-trade** freight is trans-shipped here. As a result, a well-organized **criminal** system has developed in the port complex, and law-enforcement authorities have turned out to be helpless against it.

In discussing the problems of the southern ports (See *The Port is Seething But Nothing is Visible*, *Rossiyskaya Gazeta*, 17 July 2001), deputy plenipotentiary Mikhail Fetisov pointed out that in the Novorossiysk port in particular, according to him, new wharves costing \$70 million do not work for the government. The deputy plenipotentiary did not go into detail in the newspaper interview. Therefore, I would like to add to his story, why and for whom Novorossiysk's ports do work.

To be more precise, not all the wharves, just two -- #40 and #41. They permit servicing ships with cargo capacity of up to 25,000 tons and are intended for general freight (metal, special equipment, and so forth) in both closed and open storage.

These are new wharves. Like three others (#39, #39a, and #39b), they were built using state funds thanks to the federal targeted program "Restoration of Russia's Commercial Fleet." Considering the deficit in trans-shipment capacity (according to Ministry of Transport specialists this amounts to 70 million tons a year), a resolution was passed by the RF government on developing maritime commercial trade in the port of Novorossiysk; it was proposed to create a new large transport complex in the eastern part of the city, the so-called "New Port," the start-up of which would permit putting Novorossiysk's potential as Russia's Southern sea gate into action.

The construction of the hydrotechnical part of five wharves, which was begun in 1996, was completed last year. According to the government's resolution, an open joint-stock association was to be created for the purpose of completing construction of New Port and for its future operation.

At a session of the RF Government Commission on Operational Issues of 3 November 1999, support was given to an initiative made by the Krasnodar Kray administration to create the open joint-stock association "New Port," from ZAO [Closed Joint-Stock Company] Russkiy Konteyner -- the leading operator of containerized shipping -- OAO [Open Joint-Stock Company] Novorossysk Junction Transport-Expeditionary Enterprise NUTEP [Novorossiyskoye uzlovoye transportno-ekspeditsionnoye predpriyatiye] -- which serves the steamship complex -- and the North Caucasus Railroad.

But then the federal program "Restoration of Russia's Commercial Fleet" stumbled. The head of the maritime port administration [MAP] of Novorossiysk, Viktor Popov, tripped it up. True, he is now a former head of administration. He was removed from this position after a number of scandals and the initiation of criminal proceedings connected with corruption and exceeding official authority.

But back then, in March 2000, Viktor Popov let the horse run free. In blatant violation of the law he arbitrarily concluded an agreement with ZAO Region Treyd [Trade Region], according to which it was obligated to provide financing for the work on completing the construction of wharves #40 and #41. Why such fortune fell to this ZAO, one can only guess. But nasty tongues assert that the given firm was under the personal control of Viktor Popov. And it required almost six months for the Russian Ministry of Property to annul this deal.

Only the head of MAP Novorossiysk Viktor Popov was no one's fool. So while the argument went on over the ZAO Region Treyd, he found another means to appropriate the wharves. At the end of September 2000, a certain firm, ZAO Portholding, came to light, whose general director is Yu. Aksenov. After a short period of time, Viktor Popov, in agreement, we'll say, with the Krasnodar Kray Committee on State Property Management concluded a contract with this company. According to this contract, wharves #40 and #41 and the adjacent 3.07 hectares of property were given over in a long-term lease (10 years) to Portholding without conducting any kind of tender. The total value of this contract was more than \$15 million. This was at the beginning of this year.

And again paper wandered about the city and offices. On 16 February, Deputy Minister of Property Relations, S. Molozhavy, sent a letter to Krasnodar to the chairman of the Committee on State Property Management. In it he wrote clearly that: "The conclusion of a lease contract with ZAO Portholding contradicts resolutions passed at the interdepartmental

conference of 8 February 2000. In connection with this the Russian Ministry of Property directs the Committee on State Property Management of the kray to invalidate the lease contract with ZAO Portholding. The first reaction to these categorical directions occurred four months later. Now the department of property relations in the person of its new leader, V. Bondar, filed a petition to the Krasnodar Kray Civil Court to have the leasing contract with ZAO Portholding declared invalid. Afterward, the procurator of Krasnodar Kray initiated **criminal** proceedings based on the materials of an examination of the legality of the contract to lease state property made by ZAO Portholding's general director, Yuriy Aksenov. Does this mean that justice triumphed? Alas. Even the ambiguous attention devoted to the situation by State Duma deputies could not move the case from a dead end. The state property was not returned to the state. In addition, even stranger things came to light. In an inquiry made by State Duma deputy S. Shishkarev, which he sent on 1 August to Minister of Transport S. Frank, the international public "National and International Security Foundation," being the only founder of ZAO Portholding, immediately upon the signing of the leasing contract sold 100 percent of its shares to a certain OOO [limited company/limited liability company] Bars. Its owner, in turn, turns out to be -- who ever would have thought it -- Yu. Aksenov. Thus, by means of a simple scheme he became owner of a complex created at the expense of the federal budget worth \$15 million.

It is difficult to relate all the events which took place in this story to fortuitous coincidence. Most likely this is only the tip -- the lines are deep -- of the struggle to transfer state property to private hands. Which is why there were many words and little action regarding it. The scandal is not even noticed for some reason in the office of the plenipotentiary of the Southern Federal District. The only unclear thing in this story is the position of the state structure called the Ministry of Transport -- whose side is it on?

[Description of Source: Moscow Rossiyskaya Gazeta in Russian -- Government daily newspaper.]

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EXHIBIT 48

[\[Go To Best Hit\]](#)*Unclassified*

Document ID: CEP20010718000259
Entry Date: 07/18/2001
Version Number: 01

Region: Central Eurasia

Sub-Region: Russia

Country: Russia

Topic: CRIME, DOMESTIC ECONOMIC

Source-Date: 07/17/2001

Conditions at Southern Ports Viewed

CEP20010718000259 Moscow Rossiyskaya Gazeta in Russian 17 Jul 01

[Interview with Mikhail Fetisov, deputy plenipotentiary of the Southern Federal District, by Galina Nikolayeva; place and date not given: "Everything Is in Full Swing at the Port, But Nothing Is Visible" -- taken from html version of source provided by ISP]

[FBIS Translated Text]

Even infamous **criminal** cases disappear into the water

Three conferences in nine months have already been held in the Southern Federal District, conferences devoted to the problems of the maritime **trade** complex. At the most recent one, they spoke with alarm about the fact that Russia was losing its position as a sea power, and this was threatening the national security of the country. We conducted an interview concerning this problem with Mikhail Fetisov, deputy polpred [plenipotentiary].

[Nikolayeva] As we know, the southern ports are powerful economic structures: almost half of Russia's **foreign-trade** cargo is transshipped here. What is the state getting from the energetic labor activity of the joint-stock companies?

[Fetisov] Depressing as it is, the condition of the merchant fleet today is characterized by negative trends. The number of ships under the Russian flag is being reduced and the currency receipts are decreasing, and this means that fewer taxes "trickle" into the budgets. This is happening because state monitoring over the activity of the ports has weakened. At one time, privatization was carried out hastily and without any serious study. Many mooring structures were leased out under quite strange conditions.

[Nikolayeva] To what are you referring?

[Fetisov] The market value of the berths was obviously understated when they were leased out. Let us take the Tuapse Maritime Trade Port. The leasing agreement on it was concluded for a symbolic payment -- 3 percent of the residual value, which decreases each year and is approaching zero.... The leasing payment in the Southeastern Cargo Region of the Port of Novorossiysk was also levied on understated principles, and with interruptions. New berths valued at \$70 million are not working for the state: the loss has already constituted more than 230 million rubles [R]. Incidentally, most of the agreements are drawn up in such a way that the lessees bear no financial liability for their violations. No one, for example, even thinks about engaging in any repairs of the hydro-structures. They are getting dilapidated, and their balance-sheet value is falling. Federal legislation prohibits the lessees from subletting the areas. And why? At the Port of Novorossiysk, some of the berths are used by the OAO [Open Joint-Stock Company] Chernomortransneft, and some by the OAO Novorossiysk Cement Plant. But in this case, the lessee is the maritime trade port. There are also quite a few gross violations of legislation in the sphere of land relations. In Novorossiysk, the land was turned over on a gratuitous basis to the commercial organization OAO NMTP (and perhaps only for leasing!); at the Port of Astrakhan, the payment for the area used goes exclusively into the city treasury, but it should be transferred in equal shares into the budgets of all levels. In short, the people are getting little benefit from this state property.

[Nikolayeva] Surely there is someone to make answerable for these losses? Or are the existing laws so bad that they make it impossible to introduce order in our native land?

[Fetisov] Many of our laws are truly imperfect. Moreover, there are a lot of loopholes for getting around them. Practically all the ports in the Southern District had to change their privatization plans, eliminating the violations. There are a number of legal decisions on returning the illegally privatized objects to federal ownership. As it has turned out, however, these decisions are for the joint-stock companies Tuapse SRZ [Ship-Repair Yard], Novorosleseksport and Novorospishcheprom. The Novorossiysk Fishing Industry Company is not obliged to do anything: they... do not want to return the property to the legal owner. The most surprising thing in this story, however, is the fact that there followed a decision of the Higher Arbitration Court on... halting the final process on these matters until they were considered in the supervisory authority court of the Higher Arbitration Court.

[Nikolayeva] Can this red tape go on for years?

[Fetisov] Precisely right. In general, there is a great deal here that is strange. Let us say, in connection with the decree of the administrative head of Krasnodar Kray "On the Loss of Economic Security at the Seaports of the Azov-Black Sea seaboard," and almost 200 **criminal** cases were instituted in the course of the work of the Interdepartmental group in 1998. The Russian MVD [Ministry of Internal Affairs] even created a special Azov-Black Sea UVD [Internal Affairs Administration] in transport, laying on it the responsibility for establishing order in the ports of the two seas. But the pressure put on the shadow economy quickly failed. A considerable number of the **criminal** cases were dismissed.

[Nikolayeva] Why did this happen?

[Fetisov] I think that the law-enforcement agencies ran up against a well organized **criminal** system in the port complex. The appeal of the polpred Kazantsev to the chairman of the country's government mentioned the inefficient work of the police, the customs and the tax police. On the instructions of Mikhail Kasyanov, the MVD collated the answers of the federal departments in connection with the questions that we raised. I will say frankly: the answers did not suit us.

[Nikolayeva] For what reason?

[Fetisov] We did not like the reassuring tone of the answers. They essentially amount to the following idea: "Don't get upset, everything is under control in the ports." The MVD's Azov-Black Sea Administration of Internal Affairs for Transport is given credit for the fact that last year twice as many violations were revealed. But let us look at what is hiding behind the "favorable" indicators. Out of 176 of last years crimes with an economic direction, 112 **criminal** cases were brought to court. And just which of the defendants were sent to the dock? Salesmen and bartenders, who caused the customers losses of from R10 to R30. But here are a few "infamous" cases, dismissed "for lack of evidence": The joint-stock company Novorosybprom sold the trawler Atoll abroad (no customs payments were made, and an especially large loss was incurred); the Duglas Company sold the motor ship Sormovskiy (a loss of R180,000).

We also ran up against the open unwillingness of the staff members of the UVD for Transport to get to the truth. Twice the "guardians of order" answered the staff members of the polpred, apropos of the existence of a sublease between the Chernomorsktransneft Joint-Stock Company and the Sheskharis Company: there are no such relations between the owners of the objects. Only on the third attempt did the staff members succeed in urging them on to "decisive" actions: an answer was received on instituting a **criminal** case for the fact of illegal entrepreneurship (loss -- R142 million). We have many "remarks" addressed to the Southern Customs Administration. Last year 78 **criminal** cases were instituted in the port complex of Southern Russia, but 42 percent of them were dismissed or suspended. Also interesting is the "geography" of the indicators: the Yeysk and Taganrog customs in general failed to reveal cases of smuggling, and in the most powerful Novorossiysk Complex -- there were up to 4 cases! In Temryuk, for example, out of 22 **criminal** cases, 21 "fell apart."

[Nikolayeva] If I have understood you correctly, the staff members of the polpred are convinced of the need for tough measures with respect to establishing order in the ports. Does strict state regulation not have any effect on the incomes of the companies?

[Fetisov] At any time, we have only to start up just one major case involving the sale of domestic ships abroad and they raise a racket about the attack of reactionary forces and a threat to democracy as a whole. Business in the ports should be not only profitable, but absolutely transparent for the state. The legal confusion and impunity for the crimes committed prevents the solution of many economic problems and even of questions of navigation safety. Let us take the work of the private pilot services: not a single one of them is in a position to cover the losses even in an insignificant accident in the water area. The positions of the RF Ministry of Transport and the polpred group coincide here: Navigation safety is the prerogative of the state services. As far back as November of last year, we came to an agreement on creating a state pilot service in Novorossiysk. Nevertheless, to this day there is no RF government decree which would determine the

procedure for the work of the pilot services in Russian ports. But the RF Ministry for Antimonopoly Policy and Support of Entrepreneurship is in general standing up for competition between various organizations in the sphere of navigation safety. Incidentally, it is also not very clear as to for which considerations this ministry abolished the procedure of having the maritime administrations of the ports collect ecological samples from ships, and because of this, state monitoring of these financial flows is completely lost.

[Nikolayeva] At a conference in Taganrog, Sergey Frank, the RF minister of Transport, presented a target-oriented federal program, "Modernizing the Russian Transport System," and stated that the country's geopolitical and military-strategic interests would dominate in our ports, and that the need had grown urgent to reform the system of state management of seaports. What global projects is it "proposed" that the Southern Federal District develop?

[Fetisov] Many recommendations from the center coincide with our own ideas, set forth in the "Program of Socioeconomic Development of the South of Russia up to 2006." These are: the construction of the modern commercial Port of Olya, which, together with Astrakhan and Makhachkala will constitute a unified transport complex on the Caspian; the signing of an international agreement on use of the Caspian basin, determining the status of the Azov Sea and the Kerchenskiy Strait; the development of the Kochetovka multiple-use hydro-development; and, of course, the "North-South" transport corridor. The main export stream of oil today goes through the south, and it is on the shoulders of the Federation components of our district that the load of operating the Caspian Pipeline Consortium lies. We must think about the development of oil-transshipping ports.

[Description of Source: Moscow Rossiyskaya Gazeta in Russian -- Government daily newspaper.]

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EXHIBIT 49

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Document ID: CEP20011029000005
Entry Date: 10/29/2001
Version Number: 01

Region: Central Eurasia**Sub-Region: Russia****Country: Russia****Topic: CRIME, DOMESTIC ECONOMIC, INTERNATIONAL ECONOMIC****Source-Date: 10/29/2001****Kaliningrad Oblast Economy Corrupted by Open Border***CEP20011029000005 Moscow Vedomosti in Russian 29 Oct 01*

[Article by Bulat Stolyarov: "An Examination of the Economic Structure of Kaliningrad Oblast" -- taken from HTML version of source provided by ISP]

[FBIS Translated Text]

Before 1999, according to statistics, each resident of Kaliningrad Oblast, even the babies, smoked 20 packs of cigarettes a day. Around a million motor vehicles went through **customs** here between 1990 and 1999, but only 220,000 cars are registered in the oblast now. It would seem that the privileges contributing to these amazing developments no longer apply on the same scale as before, but the oblast economy has not changed.

Traditions Never Die

In 1999, naval personnel lost the right to bring motor vehicles into Kaliningrad Oblast for free. Limits were finally imposed on duty-free and tax-free imports for internal consumption (those privileges were the cause of the universal "nicotine addiction" in the region, explained Aleksandr Anisimov, an expert from the Northwestern Strategic Development Project Center). The region's smugglers, big and small, were running their businesses so efficiently by then, however, that they are still operating without any problems.

Many privileges still exist. The Comptroller's Office estimates their cost at a quite substantial figure--10 billion rubles a year (for the sake of comparison, the whole Kaliningrad Oblast budget for 2001 totals 4 billion rubles). The smugglers, however, actually seem to have nothing but contempt for those privileges now. "Duty-free cigarette import quotas are sold at special auctions," one of the oblast's most prominent illegal

dealers told Vedomosti, "but I do not even go to those auctions. I pay all of the duties and take them (the cigarettes) through **customs** on the regular Russian grounds, because cigarettes cost two or three times more in Poland than they do here anyway. I prefer this kind of high-volume business."

The Vedomosti correspondent witnessed how goods from Kaliningrad are taken into Poland at the border crossing in the town of Mamonovo. There are lines of 200-500 cars waiting at this crossing at any hour of the day or night. Oblast residents do not need a visa to enter Poland. Furthermore, Russian regulations allow each resident of the region to take 20 cartons of cigarettes out of the oblast duty-free. The shuttle trader simply buys cigarettes at a wholesale stand on this side of the border, crosses the border (after waiting in line for 12-15 hours), and sells the cigarettes to a Polish wholesale stand 100 meters from the border. The people who wait in line regularly (the same cars are there every day, year in and year out) say that the net profit on this simple operation is \$1-2 per carton. They say the profit margin would be even higher if it were not for the Polish **customs** inspectors (Polish regulations allow the visitors to bring only one carton, not 20, into Poland), who sometimes confiscate the goods unless they can agree on some kind of arrangement. "That is all right," said an elderly man, a former serviceman, who crosses the border almost every day with his wife, "because we also bring a bottle of vodka each and a full tank of gas, and the difference in those prices is also substantial." This border trade now has every element of the necessary infrastructure: Local women feed the shuttle traders sausages and sell them drinks around the clock, and skilled craftsmen in local garages rebuild car interiors, installing secret compartments where goods can be hidden from **customs** inspectors. According to the estimate of the Northwestern Strategic Development Project Center, at least 100,000 oblast residents are directly engaged in this border trade.

The tobacco dealer acknowledged that cigarettes worth at least \$60 million are transported in that way just to Poland each year.

"The border trade and the related semi-legal businesses constitute the whole economy of the six border cities in Kaliningrad Oblast," said Aleksandr Shamshiyev, a bureau member of the local RSPB [Russian Union of Industrialists and Entrepreneurs] branch and the head of Anyuta, the largest travel agency in the oblast. "They have no tax base whatsoever. The cities were once important in national defense, but now the bases have been shut down, and the people have to make a living however they can." Sugar is taken across the border, in addition to tobacco and liquor, to Lithuania (sugar is subject to excise taxes in that country). Wagons full of granulated sugar wait in line on this side of the border, and empty wagons wait on the other side. **Customs** officials say that 20-30 vagrants carry five tonnes of sugar in polyethylene packages across the border each night, and all of this is completely legal.

Amber Territory

Another unique populated community in Kaliningrad Oblast with an unconventional way of doing business is the town of Yantarnyy, where a combine with the same name has a world monopoly on amber mining. The enterprise is in a highly critical state. Vyacheslav Shestakov, the combine's chief engineer, told Vedomosti that Yantarnyy owes 40 million rubles to creditors, its accounts have been frozen, and all settlements have to be made from the accounts of its clients.

Officials in the Ministry of Economic Development and Trade, where the development program for the oblast was drawn up, believe that ineffective management is the cause of all of the enterprise's problems. Gref's agency estimates the world market for amber items at \$200 million, but the monopoly collected less than \$1 million in forex receipts last year and \$1.2 million so far this year.

The reason for this sizable discrepancy between potential and actual receipts is that jewelry makers account for most of the added value in the amber market. The Yantarnyy Combine mainly sells raw material, however, despite its colossal jewelry-making infrastructure. According to its official balance sheet, the combine sold 200 tonnes of amber last year. Kaliningrad Oblast Duma Deputy Sergey Kozlov, who has studied the combine's financial and commodity flows, maintains that most of the crude amber is taken out of the mine illegally. Judging by all indications, he is correct. The mine is on the grounds of the combine, and the Vedomosti correspondent could see that it is completely exposed. Combine Chief Engineer Shestakov said, "A fence is not the answer." In his opinion, the miners' output norms are so high that they simply do not have the time to mine any amber "for themselves." Besides, there are six guards on duty on each shift (the combine has its own security service). One of the workers admitted in a conversation with the Vedomosti correspondent, however, that it is not difficult to reach a compromise with the guards. The worker said that about half of the crude amber "bypasses the accounting office" when it leaves the combine. Engineer Shestakov, on the other hand, thinks they steal "no more than 15 percent of total output." Total output is 400 tonnes a year.

Border traders say that the methods of amber contraband are no different from the methods used to take tobacco or sugar across the border. "As long as the Polish **customs** inspector can charge \$10 for not searching a vehicle, he does not care what it is carrying," the people waiting in line observed. The Russian border guards, however, categorically deny the possibility of amber smuggling on an industrial scale. "When officials in the Ministry of Economic Development and Trade say that the market in Poland and Lithuania has a two-year supply, they are not admitting the possibility that these could be past reserves," said Sergey Lapchenko, the chief of the Kaliningrad **Customs** Administration. "The only thing I can tell you for certain is that we prevented the attempted smuggling of seven tonnes of amber this year, whereas we caught only 130 kilograms crossing the border last year."

Vitaliy Zhdanov, the head of the oblast Department of Economic Development and Trade, says that "recategorization is common in amber export records: Crude amber is taken out of the country duty-free as costume jewelry." The oblast **customs** chief believes the situation can be corrected: first, by putting the police in charge of law and order at the mine and, second, by levying **criminal** penalties for amber smuggling (it is now an administrative offense).

The Ministry of Finance, Ministry of Economic Development and Trade, and oblast administration have already come up with their own plan for the restructuring of the amber industry. In accordance with this plan, the Yantarnyy Combine GUP [state unitary enterprise] would keep only the mine, and strict oversight would be established there. The processing enterprise would be auctioned off and would be able to operate in the competitive market. A special amber exchange would handle amber sales. All of the oblast jewelers could participate in the trading sessions. Only the current combine

management is categorically opposed to these changes, because it does not want the extracted amber to be controlled by anyone else. Shestakov feels that the combine should get financial assistance to buy gold. Then jewelry could be made right on the combine grounds.

Deputy Kozlov categorically objects to this plan: "They already received enough assistance when amber mining was granted folk-arts-and-crafts status at the beginning of the year, and now they no longer have to pay federal taxes, but they still are not paying their debts."

"It Would Be Better To Require Visas"

Many businessmen in the oblast feel that the absence of visa requirements for oblast residents entering the territory of Lithuania and Poland derailed the economic development of the region instead of stimulating business. "I have legitimate business to do in Poland, but the open border is keeping me out of that country," complained Aleksey Putukhov, the owner of the largest chain of gas stations in Kaliningrad. "There is always a line of shuttle traders a kilometer long at the border, and I have to wait there 12 hours." Incidentally, local residents sell places in line closer to the border for \$10-20, and the buyer then only has to wait an hour or two.

Putukhov is in favor of visa requirements. He is supported by Maks Ibragimov, the head of the Maxick Furniture Company, whose products have to wait at the border for 3-5 days before being shipped to Europe.

Lapchenko from the **customs** service feels that there is no solution. "Even if we widen all of the border crossings to six lanes, this will only facilitate the business dealings of the shuttle traders, who will then be able to cross the border two or three times a day instead of just once. The lines will not be any shorter," he declared. Setting different rules for shuttle traders and freight carriers, on the other hand, is prohibited by the Constitution, Lapchenko suggested, because all citizens have equal rights.

Judging by all indications, visa requirements might be instituted soon on the border with Poland and Lithuania. Those countries will be admitted to the EU at some point and will have to set visa requirements for countries not belonging to the European Union. In that case, the oblast, according to the local RSPB branch, will have to come up with new development plans for the six border cities. In addition, according to Shamshiyev from the Anyuta Travel Agency, income from tourism will be reduced by at least 50 percent.

There are high hopes for state aid in the region. In preparation for Kasyanov's visit, which was scheduled for this week, people started painting the walls light-blue in the oblast administration building, but only in the hallways Kasyanov will see--leading from the front door to the governor's office. The oblast budget deficit this year is almost 10 percent.

The Prime Minister will not come to Kaliningrad this week, however. The visit was originally postponed because Vladimir Putin was planning to visit the oblast in Kasyanov's place. The President also had to cancel his trip, however, and the government press service reported that the new date of Kasyanov's visit is being coordinated with the prime ministers of Poland and Lithuania, who want to be in the city at the same time as their Russian colleague.

Heaven is too high, and Moscow is too far....

[Description of Source: Moscow Vedomosti in Russian -- daily business paper published jointly with The Wall Street Journal and Financial Times; reportedly friendly with Kremlin]

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EXHIBIT 50

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Document ID: CEP20010510000132

Entry Date: 05/10/2001

Version Number: 01

Region: Central Eurasia, West Europe**Sub-Region: Russia, Nordic Countries****Country: Russia, Finland****Topic: INTERNATIONAL POLITICAL, LEADER, MIGRATION****Source-Date: 05/10/2001****Russian foreign minister says EU membership not on current agenda***CEP20010510000132 Moscow ITAR-TASS in English 1158 GMT 10 May 01*

[FBIS Transcribed Text]

Russian foreign minister says **EU membership** not on current agenda

Text of report in English by Russian news agency ITAR-TASS

Petrozavodsk, 10 May: On his way for a visit to Finland today, the Russian minister of foreign affairs, Igor Ivanov, made a stopover in Petrozavodsk, capital of Russia's northwestern republic of Karelia. He met the republic's leaders to discuss expansion of regional cooperation which, he said, will form the basis of Russia's foreign policy.

Chairman of the Karelian government Sergey Katanandov said a pilot international project "Euroregion Karelia" has been prepared designed to boost the republic's cooperation with Finland and level out the standards of living on both sides of the border.

Igor Ivanov noted that relations between Russia and Finland are characterized by stability and said the relations with this country were an example to be followed in the establishment of good-neighbourly relations with the countries which aspire to join the European Union.

Ivanov declared that Russia and the European Union must seek to consolidate relations. "I cannot imagine Russia's **membership** in the European Union at present. But it is necessary to make efforts to achieve a high degree of rapprochement of the countries."

As concerns Russia's relations with the Schengen member states, he said Moscow was conducting negotiations with the European Union on the introduction of "a soft regimen in the relations across the border". "It would be in the interests of the people's of all countries if we proceed from the need to secure conditions for normal movements of people, transport and capital," Ivanov said.

The Russian minister who looked into Karelia's plans for the development of its foreign

economic relations during his visit to Petrozavodsk said the Russian foreign ministry would continue to assist the regions in their efforts to accede to the foreign markets.

Ivanov wound up his brief visit to Petrozavodsk and left for Finland on Thursday [10 May] afternoon.

[Description of Source: Moscow ITAR-TASS -- main government information agency]

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